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NEGLECTED ALTERNATIVES FOR INVESTOR SELF-HELP: THE UNREGISTERED INVESTMENT COMPANY AND THE FEDERAL CORPORATE LAW

Parker M. Nielson*

Introduction

Clearly, the concept of an "implied" private action¹ based upon congressional proscriptions set out in the various federal securities laws is sufficiently broad in scope to include provisions of the Investment Company Act of 1940² [hereinafter referred to as the Act]. Nevertheless, the provisions of that Act were not relied upon as a basis for recovery by a shareholder against the management of a company which had failed to register under its provisions in any reported case until *Esplin v. Hirschi*³ in September, 1968.⁴ When it is considered that in an appropriate case it is a potent tool in stockholder litigation, the delayed entry of the Investment Company Act into the implied liabilities arena is surprising, for the comprehensive system of fiduciary obligations imposed by the Investment Company Act may provide relief to an aggrieved investor which is more effective and more simplified than that available under the more familiar anti-fraud provisions of the Securities Act of 1933⁵ and the Securities Exchange Act of 1934.⁶ To date, the private litigation that has arisen under the Investment Company Act has been concerned almost exclusively with the failure of licensed mutual funds to comply with the regulatory provisions of the Act dealing with management contracts.⁷ Many factors, including the complex nature of the Act itself, the attendant difficulty in the mastery of its provisions, and the evident reluctance of management to hazard a judicial test when its conduct has been challenged,⁸ have contributed to the absence of any extensive private litigation of the provisions of the Act, particularly with reference to unregistered companies. This article is devoted to an analysis of such possible implied actions as an aspect of the regulation of investment companies.

Such an action might take many different forms. The possibilities are at least as numerous as the fiduciary duties imposed by the Act,⁹ and as varied

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1 See, e.g., *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), and the multitude of cases following the so-called "Kardon Doctrine."

2 15 U.S.C. §§ 80a-1 to 80a-52 (1964). For a brief sketch of the background and legislative history of the Act, see *Brown v. Bullock*, 194 F. Supp. 207, 217-18 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

3 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 37 U.S.L.W. 3369 (U.S. April 1, 1969) (No. 1013). The author was counsel in *Hirschi* in the trial court as well as on appeal.

4 *But see* note 8 *infra*. See also *Cogan v. Johnston*, 162 F. Supp. 907 (S.D.N.Y. 1958), where a motion to dismiss such a claim was denied.

5 Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1964).

6 Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (1964) and Rule 10b-5 adopted pursuant thereto, 17 C.F.R. § 240.10b-5 (1968).

7 E.g., *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961).

8 Actions have been initiated which apparently would have determined many of the questions posed in this article, but they have either not been tried or their determination has not found its way into legal literature. See, e.g., cases cited at notes 55, 61 and 85 *infra*.

9 See 15 U.S.C. § 80a-1(b) (1964), reproduced in full at note 59 *infra*, which defines fiduciary duties as they pertain to unregistered investment companies.

as the resourcefulness of the lawyer who undertakes to employ the Act in his quest for the relief of an aggrieved stockholder. A catalogue of these possibilities is, of course, impossible, particularly in the absence of any extensive litigation of the provisions of the Act. However, some definite points of departure will be examined.

Moreover, the availability of an implied cause of action against the unregistered investment company is neither a matter of limited concern, nor is it of interest only as a possibility for stockholder litigation. Indeed, the currency of such unregistered companies is far greater than might be supposed. Those engaged in counseling the corporate community should be alert to recognize the type of company which the Act purports to regulate and careful to arrange its affairs so that the objects of the regulatory scheme are satisfied. Otherwise, the penalties which might follow the disregard of these important provisions are considerable.

I. The Scope of the Problem

Although the type of investment company under consideration may result from a calculated disregard of the registration requirements of the Investment Company Act by a corporation subject to its provisions, the failure to register may also be a result of simple ignorance of the provisions of the law — what has been aptly described as the “inadvertent investment company.”¹⁰ The promoters or management of such a company may have never intended to create an “investment company” at all, and may even claim that they are engaged to some degree in other business pursuits; yet by reason of the accumulation of an investment portfolio, the company may nevertheless fall within the Act’s definition of an “investment company.”¹¹ The definition, in practical effect, declares that a company will be deemed to be an “investment company” if (1) it says that it is, or (2) if it is in fact engaged primarily in the investment company business¹² and is not otherwise exempt.¹³

10 See Kerr, *The Inadvertent Investment Company: Section 3 (a) (3) of the Investment Company Act*, 12 STAN. L. REV. 29 (1959). See also SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968).

11 15 U.S.C. § 80a-3(a) (1964) provides:

When used in this subchapter, “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) [Part (2) refers to “face-amount” certificate companies, which are not discussed because they are rarely encountered.]

(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 per centum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

12 See *Hearings on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency*, 76th Cong., 3rd Sess., pt. 1, at 176-77 (1940). This is, of course, an oversimplification of a complex definition, the detailed analysis of which is beyond the scope of this article. It should be noted, however, that the first part of the definition, quoted in note 11 *supra*, refers to transactions of companies *primarily* engaged in investing in *securities*, while the latter part of the definition does not employ the term “primarily” but substitutes a somewhat arbitrary standard for determining when a company is actually engaged in the investment company business, *i.e.*, if its investment securities represent forty per cent of its total assets exclusive of cash and government securities. “Investment securities” are defined in note 16 *infra*. The

Any company falling within the first part of the definition would, presumably, recognize its status and comply with the regulatory scheme.¹⁴ If it did not do so, action in the courts against management by its shareholders should be expected, either to recover any damages they may have suffered or to require compliance with the fiduciary standards imposed by the Act for their benefit.

The second portion of the definition may form a snare for the unwary. Under it a company will be deemed to be "engaged" in the investment company business if its liquid assets,¹⁵ which are defined by the term "investment securities,"¹⁶ equal forty per cent of its total assets other than government securities and cash, and for the purpose of this criterion an entirely static portfolio will satisfy the requirements of the definition.¹⁷ Considering the wide variety of investments which may be classified as a "security,"¹⁸ it is clear that this "statistical"¹⁹ forty per cent formula could be met by a great many unsuspecting business enterprises.

distinction between "securities" and "investment securities" must be kept in mind, since, for example, it would seem that a company which holds itself out as being engaged primarily in securities transactions is an investment company even if its portfolio consists of securities which would be exempt under the latter part of the definition, as, for example, if it trades in "government securities," while a company claiming to be engaged primarily in industrial ventures other than investments will become an "inadvertent" investment company only if its "investment securities" reach such a level that regulation is required according to the standards of the Act. For a more complete discussion of these matters, together with other subtleties involved in the definition, and the complex exemptions and exclusions of 15 U.S.C. §§ 80a-3(b), (c), and § 80a-6 (1964), see Kerr, *supra* note 10; Garrett, *When is an Investment Company?*, 37 U. DER. L.J. 355 (1960).

13 For exceptions and exemptions under the Act, see 15 U.S.C. §§ 80a-3(c), 80a-6 (1964). They are numerous and complex, and their discussion is beyond the scope of this article. See also Garrett, *supra* note 12, at 359-61. Cf. Hoover v. Allen, 241 F. Supp. 213, 246 (S.D.N.Y. 1965) (the Act is to be strictly construed against a claim of exemption).

14 But see SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968), where the court concluded that, even under 15 U.S.C. § 80a-3(a)(1) (1964), a company could become an investment company inadvertently because "[i]t would seem to be possible for a company to find itself at a given point in time to be actually engaged primarily in this business, even though it originally did not intend to be so engaged." *Id.* at 27-28. (Emphasis added.)

15 The Tonopah Mining Co. of Nevada, 26 S.E.C. 426 (1947). See text accompanying note 26 *infra*. See also Kerr, *supra* note 10.

16 "Investment securities" are defined in 15 U.S.C. § 80a-3(a) (1964) as follows:

As used in this section, "investment securities" includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies.

17 The Atlantic Coast Line Co. 11 S.E.C. 661, 663-64 (1942); Kerr, *supra* note 10, at 34. It is important to note that the section 3(a)(3) definition refers to "owning" of "securities." Thus it is not necessary for the company to actively trade in its portfolio if the other conditions of the definition are met. But see SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 31 (S.D.N.Y. 1968), where the court declared that the term "[b]usiness" implies continued activity."

18 See, e.g., Tcherepnin v. Knight, 389 U.S. 332 (1967) (savings and loan passbook), court of appeals decision commented on in 43 NOTRE DAME LAWYER 124 (1967); SEC v. Joiner Leasing Corp., 320 U.S. 344 (1943) (interests in oil properties); Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967), cert. denied, 391 U.S. 905 (1968) (contracts for sale and management of live beavers).

19 The section 3(a)(3) definition was originally characterized as a "statistical" formula by counsel for the SEC in hearings on a preliminary draft of the Act:

Paragraph 2 of section 3(a) [which is identical with section 3(a)(3) as enacted] sets forth what we call a statistical formula which will be of assistance in determining whether a company is an investment company or is not an investment company. . . .

. . . . Our approach is that an investment company, for the purpose of this proposed legislation, is a company which is engaged in the business of investing and reinvesting in securities, or is a company which invests and reinvests or holds securities of other

It is also important to consider provisions of the Act which declare that an investment company cannot cease to be an investment company without obtaining SEC approval,²⁰ for it has been urged that an unregistered company is subject to that limitation to the same extent as a registered company.²¹ If the unregistered company is so subject, which seems to be the case based upon a plain reading of the Act,²² it would follow that even an occasional transgression of the forty per cent barrier established by the second part of the definition will render a company subject to all of the provisions of the Act;²³ and the attendant exposure to civil liability might continue until it has been determined, pursuant to proper application with the SEC, that the public interest no longer requires regulation. Such an interpretation has been advanced by the SEC in its enforcement actions under the Act.²⁴ If such a construction is proper in the context of a request by the SEC for injunctive relief, it would appear equally proper, and perhaps even mandatory, when one of the investors the Act was designed to protect claims to have been injured by such an occasional transgression.

This brief discussion of the section 3(a) definition of an "investment company" should suffice to indicate the broad scope of the Act. Indeed, it should be immediately apparent that a great many corporations, perhaps even some which are substantial, well established, and otherwise managed by prominent and responsible members of the business community, will fall within the broad sweep of the statistical definition of section 3(a) (3). Banks, insurance companies, finance companies, employees' stock bonus, pension or profit sharing trusts and even the small investment clubs which exist in large numbers throughout the country are among the companies plainly within the scope of the definition. However, these businesses, along with many other businesses which are by definition within those provisions, are exempt under the manifold exemptions and exclusions of sections 3(c) and 6.²⁵ Generally, these exempt businesses are companies which were thought to be effectively regulated by other provisions of state or federal law. There are many others which are not exempt, including those which are organized with the avowed purpose of functioning in a fashion "similar" to that of the companies exempted by sections 3(c) and 6, either as part of a scheme to avoid the regulatory pattern or in total oblivion of the provisions of the Act. Not the least important, for these purposes, is the company which is organized as an industrial enterprise but later evolves into a corporation fitting the section 3(a)(3) definition. These corporations, organized or existing

corporations, provided that at least 40 percent of its assets consists of marketable diversified securities. *Hearings on S. 3580, supra* note 12, at 176-77.

20 15 U.S.C. §§ 80a-1(b)(6), 80a-8(f) (1964).

21 *SEC v. S & P Nat'l Corp.*, 360 F.2d 741, 746 (2d Cir. 1966).

22 See authorities cited in notes 20 and 21 *supra*. See also note 63 *infra*, for authorities holding that securities laws are to be interpreted strictly against any claim of exemption.

23 *But see SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), where it was held that "a company is entitled to a reasonable time within which to turn around, so to speak, to make up its mind what business it will henceforth engage in." *Id.* at 31. Yet, in another connection, the same court held that "[t]he statute does not recognize an exception for the business that defendants claim Fifth is and was engaged in, i.e., the business of acquiring control of other companies." *Id.* at 30. Since the defendant was found to be an investment company, it is doubtful if the case represents a limitation of the position taken in the text.

24 See *SEC v. S & P Nat'l Corp.*, 360 F.2d 741 (2d Cir. 1966).

25 See note 13 *supra*.

without the benefit of specific exemption, may be subject to the implied private action advanced in this article.

An example of such an inadvertent company was the Tonopah Mining Company of Nevada. Although originally organized as a conventional mining company, Tonopah had acquired a large portfolio of securities which it characterized as its "exploration fund." It actually operated mining properties, both directly and through majority owned subsidiaries, but over a period of time its subsidiaries had become largely inactive and its operation of all but one mine had been discontinued. Tonopah's investment portfolio, consisting in large part of mining securities, increased in importance as its mining activities decreased; by the time of the hearing,²⁶ these securities comprised ninety-four per cent of its total assets and were the source of most of its income. Under these circumstances the SEC determined that the company's mining operations had become incidental to its investment activities and, therefore, required Tonopah to register as an investment company.²⁷

In the case of an inadvertent investment company, exemplified²⁸ by Tonopah, the granting of an implied private cause of action to any shareholder claiming to be injured, based upon the proscriptions set out in the Act, is reasonable and necessary if the Act is to achieve its intended result. Moreover, the determination of such a claim should, insofar as possible, guarantee that when the funds of a public corporation are employed in an investment program (investments, it should be observed, which the shareholder might as easily engage in himself if he so desires), it is only within the framework of the careful regulatory system that Congress has established. It is submitted, further, that the paramount objective of investor protection which is evident in the adoption of this legislation makes it imperative that the stockholder be given his remedy in those situations where violations of the Act have caused him injury, even in the face of circum-

26 The Tonopah Mining Co. of Nevada, 26 S.E.C. 426 (1947).

27 The case established five non-exclusive considerations for determining when a company is "primarily" engaged in the investment company business:

- (a) Historical development.
- (b) Representations of policy.
- (c) Activities of officers and directors.
- (d) Nature of assets.
- (e) Sources of income. *Id.* at 427-32.

28 It is not difficult to imagine situations even more startling than the *Tonopah* case. For example, since the section 3(a)(3) definition refers to "investment securities" in relation to the forty per cent criterion, and since "Government securities and cash items" are excluded in computing the company's total assets, it is evident that the definition of an "inadvertent investment company" could be satisfied with "investment securities" totalling far less than 40 per cent of the company's total assets. Further, since stock of a subsidiary or affiliated corporation is an "investment security" if the issuer in question does not also hold majority control [*i.e.*, voting control, see 15 U.S.C. § 80a-2(23) (1964)], cases could be imagined in which ownership of stock in one or several affiliated corporations, as to which the issuer is the dominant but not controlling shareholder, would render a company subject to the Act even though the securities in question are a small part of the company's total assets — especially if it also had large holdings of cash or government securities. However, see the provisions of 15 U.S.C. § 80a-3(c)(8) (1964) relating to companies whose "investment securities" are concentrated, to the extent of ninety per cent, in securities of "a single issuer" of certain specified types. These provisions are of uncertain meaning, and would have been deleted entirely in the legislation proposed to Congress in 1967 by the SEC. See S. 1659 and H.R. 9510, 90th Cong., 1st Sess. (1967). In the absence of a ruling as to the company's status pursuant to an application under sections 3(b)(2) or 6(d), reliance upon the provisions would appear foolhardy.

stances indicating that the violations were inadvertent and unintentional.

Congress has determined in this Act that, to cite but a few examples, undue concentration through inequitable methods of control,²⁹ pyramiding,³⁰ and the operation of investment companies in the interest of other persons or corporations³¹ are against public policy. Even assuming the bona fides of management, the investors in a company which violates these proscriptions are as much imposed upon by the carelessness of management as in those cases where the violations are intentional. Furthermore, since Congress has declared that a high degree of trust and responsibility is essential in the investment company industry,³² the failure of management to even apprise itself of the existence of the regulatory provisions of the Act would seem to indicate an absence of that degree of responsibility, and perhaps even more so when the failure is the result of carelessness.

One of the dominant factors which motivated Congress to adopt the Act was the temptation presented by a large accumulation of liquid assets to employ them for the personal gain of those individuals managing or controlling an investment company.³³ That temptation may find expression in relatively subtle ways, such as in causing the company to invest its funds in corporations or business ventures in which management is personally interested.³⁴ Management may, in good faith, believe that such investments are sound and beneficial to the shareholders, and the related enterprise may be otherwise conducted on a high plane of business ethics. Nevertheless, following an extensive study of the problem Congress has determined that such transactions are unlawful and contrary to the public interest. In the interest of the shareholder, these and the many other standards imposed by the Act³⁵ should be rigidly enforced without regard for the motive or lack of motive of management in any particular alleged violation of the Act.

In other connections it has been held that a good motive is entirely irrelevant when the courts are engaged in enforcing the securities laws, and "[t]he fact

²⁹ 15 U.S.C. § 80a-1(b)(4) (1964).

³⁰ *Id.*

³¹ *Id.* § 80a-1(b)(2) (1964).

³² *Id.* § 80a-1(b)(4) (1964).

³³ This is implicit in *id.* § 80a-1(b)(2) (1964). See also *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), where the court observed:

[T]he legislative history shows that the purpose of the Investment Company Act was to prevent abuses which may grow out of the unregulated power of management to use large pools of cash. . . .

Employing a company's cash to acquire control of other companies, thereby gaining access to their cash which, in turn, can be used to acquire still more companies, was one of the activities which the Act was intended to regulate. *Id.* at 30.

³⁴ 15 U.S.C. § 80a-1(b)(2) (1964). See also S. REP. NO. 1775, 76th Cong., 3rd Sess. 6 (1940):

Basically, the problems flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of public security holders. It is obvious that in the absence of regulatory legislation, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies and that deficiencies which have occurred in the past will continue to occur in the future.

³⁵ See generally 15 U.S.C. § 80a-1(b) (1964). See also Greene, *Fiduciary Standards of Conduct under the Investment Company Act of 1940*, 28 GEO. WASH. L. REV. 266 (1959).

that the defendant was disinterested, that he had the best of motives, and that he thought he was doing the plaintiff a kindness, will not absolve him from liability"³⁶ The inclusion of a definition of the "inadvertent" investment company in the Investment Company Act appears to be a declaration by Congress that it intended the Act to be construed and applied without regard for the motive behind any particular violation. That intent should be implemented.

For those who find themselves in a questionable status under the section 3(a)(3) definition, Congress has provided ample measures, within the standards of responsibility which the Act imposes, to clarify the situation without exposure to litigation. The company may request a determination of its status as an investment company under section 3(b)(2)³⁷ or, if there is a question as to the desirability of regulation in any particular situation, an interpretive ruling or exemption may be requested under either section 3(b)(2)³⁸ or section 6(c) or (d).³⁹ If the company is not engaged primarily in the investment company business it may also rely — at its peril — on the self-executing exemption of section 3(b)(1)⁴⁰ which simply declares that such a company is not an "investment company" despite the other provisions of the Act.

However, the inadvertent investment company is not the exclusive, or even the primary, company which may be subject to the liabilities under discussion. Encompassed within the scope of the Act is the more obvious case of the promoter who acts in disregard of its provisions or attempts to avoid the regulatory scheme by devices which may be more semantic than real.⁴¹ Included in this category are many of the so-called "wheels-of-fortune" that may take the form of either a corporation or a trust,⁴² wherein the public is asked to commit hard won earnings to the care and custody of those who consider themselves possessed of peculiar business acumen. Such feigned self-esteem may, in many cases, be but a thin veil for the irresponsible practices Congress sought to eliminate in the adoption of the Act. As to such practices, greater vigilance in private enforcement, such as suggested by this article, would be a useful tonic.

II. Fundamental Elements

The availability and limit of possible stockholder relief against a company falling within the definition of section 3(a), but which fails to register under the Act, is reposed in sections 1(b) and 7.⁴³ These contain the primary provisions of

36 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192 n.39 (1961), quoting from PROSSER, LAW OF TORTS 538 (2d ed. 1955). See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), petitions for cert. filed, 37 U.S.L.W. 3255 (U.S. Jan. 14, 1969) (No. 897), 37 U.S.L.W. 3264 (U.S. Jan. 21, 1969) (No. 937), commented on in 44 NOTRE DAME LAWYER 252 (1968).

37 15 U.S.C. § 80a-3(b)(2) (1964).

38 *Id.*

39 *Id.* §§ 80a-6(c), (d) (1964). See also *In the Matter of the Trust Fund Sponsored by the Scholarship Club, Inc.*, Investment Co. Act Release No. 5524 (Oct. 25, 1968); *In re Variable Annuity Life Ins. Co. of America*, 39 S.E.C. 680 (1960); *The Atlantic Coast Line Co.*, 11 S.E.C. 661 (1942).

40 15 U.S.C. § 80a-3(b)(1) (1964).

41 *Cf. In re Variable Annuity Life Ins. Co. of America*, 39 S.E.C. 680, 704 (1960).

42 The definition of an investment company in 15 U.S.C. § 80a-3(a) (1964) refers to an "issuer," which has been held to comprehend actual or constructive trusts as well as corporations. SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959).

43 15 U.S.C. §§ 80a-1(b), 80a-7 (1964).

the Act which affect the operations of such a company. While most of the Act's other provisions are specifically limited to "registered" investment companies, it would be unwise to assume that the obligations they impose upon registered companies are not applicable with equal force to unregistered companies. In any event, it will be seen that essentially the same standards are imposed upon the unregistered company by virtue of the provisions of section 1(b). Moreover, the consequences of a failure to comply with section 7 may be determinative of a claim by the investor, and render reference to the fiduciary duties unnecessary. Also, it must be kept in mind that it is not just the company which may be subject to liability in such a failure to register, for management and promoters are also within the proscriptions of section 7.

A. Jurisdiction

Although some have urged that the courts should not entertain claims by private parties under the Investment Company Act because a private cause of action was not expressly created by Congress,⁴⁴ the development of the concept of implied liabilities is by now so well established that there appears to be little room for doubt that such actions are available under the Investment Company Act.⁴⁵ Section 44 of the Investment Company Act,⁴⁶ like corresponding section 27 of the Securities Exchange Act of 1934,⁴⁷ grants federal courts jurisdiction to entertain all actions brought "to enforce any liability or duty created by" the statute or to "enjoin any violation of" its provisions, and, since they appear to go beyond the mere authorization of enforcement action by the SEC, these clauses have been found sufficient to imply a civil remedy.⁴⁸ However, an even more compelling reason for concluding that the Act was designed to accommodate a private cause of action is the fact that section 44 also contains a grant of concurrent jurisdiction to state courts to enforce liabilities under or enjoin violations of the Act. Since other sections of the Act which authorize suit by the

44 See Shipley, *The SEC's Amicus Curiae Aid to Plaintiffs in Mutual Fund Litigation*, 52 A.B.A.J. 337 (1966), where an effort was made to discredit the concept of implied liabilities under the Investment Company Act with heavy emphasis being placed on *Brouk v. Managed Funds, Inc.*, 286 F.2d 901 (8th Cir. 1961), *vacated as moot*, 369 U.S. 424 (1962). The *Brouk* case, standing alone in its rejection of implied liabilities among all decided cases, was disavowed by the very court which authored it in *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967):

The Supreme Court in *J. I. Case Co. v. Borak* . . . emphatically endorsed implied private civil remedies for violation of § 14(a) of the 1934 Exchange Act. In so doing the Court . . . stated: "It is for the federal courts 'to adjust their remedies so as to grant the necessary relief' where federally secured rights are invaded." In coming down strongly in favor of courts implying private civil remedies where none are expressed, the strong indications are, that if given the opportunity, the Supreme Court would also find an implied civil liability in the Investment Company Act and thereby overrule our opinion in *Brouk*. *Id.* at 793.

The Shipley article was expertly refuted in *Loomis & Eisenberg, The SEC as Amicus Curia in Shareholder Litigation — A Reply*, 52 A.B.A.J. 749 (1966).

45 See note 44 *supra*. For an excellent discussion of the development of such liabilities under section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1964), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1968), see Dykstra, *Civil Liability Under Rule 10b-5*, 1967 UTAH L. REV. 207.

46 15 U.S.C. § 80a-43 (1964).

47 *Id.* § 78aa (1964).

48 See 3 L. LOSS, *SECURITIES REGULATION* 2006 (2d ed. 1961).

SEC for injunctive relief⁴⁹ refer only to actions brought in the federal courts, it is evident that the grant of concurrent jurisdiction with the state courts must contemplate private actions.⁵⁰

It was, therefore, both logical and predictable that when the question of jurisdiction over a claim of implied civil liability arose under the Investment Company Act, the courts would resolve the issue in favor of such a private right. There are, by now, quite a number of such cases which have arisen in various contexts,⁵¹ and the courts which have considered the question are unanimous in finding such an implied private cause of action.⁵²

The largest number of cases, and those constituting the most significant authority, which have held that a private cause of action may be maintained under section 44 of the Investment Company Act have involved companies that were registered under the Act. They are, nevertheless, important precedents to the type of action under consideration. If a private action is available to enforce the provisions of the Act dealing with registered companies, such an action should be equally available to enforce those portions of the Act dealing with unregistered companies.

B. Fiduciary Duties Under Section 1(b)

The Investment Company Act is composed of a detailed and comprehensive system of regulatory provisions touching almost every phase of the operation of those companies subject to its coverage. In fact, the Act has been held to constitute a federal corporate law for investment companies.⁵³ As we have already observed, however, practically all of these specific mandates of the Act are directed, by their terms, to "registered" companies, thus at least raising the question of whether relief could be granted in favor of a shareholder against an

49 See, e.g., 15 U.S.C. § 80a-35 (1964).

50 See Loomis & Eisenberg, *supra* note 44, at 750, where the authors explain that:

Section 44 of the Investment Company Act of 1940 contains a grant of jurisdiction in identical words [with section 27 of the Securities Exchange Act of 1934], differing only in that state courts are granted concurrent jurisdiction over suits to enforce any liability or duty created by the Investment Company Act. Since there can be only two types of civil actions under the statute, commission enforcement actions and suits by private parties, and since under the provisions of Section 36 and Section 42 of the act, commission enforcement actions must be brought in the federal courts, the grant of concurrent jurisdiction to state courts can apply only to private actions. To that extent, the provisions of the Investment Company Act provide a greater basis for private actions than does Section 27 of the Securities Act. (Footnote omitted.)

See also Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181 (1966).

51 E.g., *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961). For a thorough review of *Brown* and other cases see Loomis & Eisenberg, *supra* note 44, and Eisenberg & Lehr, *supra* note 50.

52 *Brouk v. Managed Funds, Inc.*, 286 F.2d 901 (8th Cir. 1961), the only case holding that such liabilities do not exist, was reversed by implication in *Greater Iowa Corp. v. Mc-Lendon*, 378 F.2d 783 (8th Cir. 1967), discussed at note 44 *supra*.

53 *Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961). See also *Levitt v. Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Aldred Inv. Trust v. SEC*, 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); *Breswick & Co. v. United States*, 134 F. Supp. 132 (S.D.N.Y. 1955), *rev'd on other grounds sub nom. Alleghany Corp. v. Breswick & Co.*, 353 U.S. 151 (1957).

unregistered company⁵⁴ for failure to observe the requirements of the Act.⁵⁵ The SEC has frequently circumvented this problem by obtaining an injunction requiring registration,⁵⁶ after which all provisions of the Act would obviously apply; but the injunction approach would probably be unsuitable and prohibitively costly to a private party — if available at all.⁵⁷

In fact, there is no reason to suppose that all of the proscriptions of the Act, including those specifically directed only to "registered" companies, do not apply with equal force to companies which fail to register.⁵⁸ The provisions of section 1(b),⁵⁹ with its enumeration of the abuses Congress sought to eliminate in the

54 *Cf.* SEC v. Wong, 254 F. Supp. 66 (D.C.P.R. 1966) and SEC v. Wong, 42 F.R.D. 599 (D.C.P.R. 1967), both of which involve the same case. In the latter decision it was held that a private party could assert a claim for relief against a registered company under the provisions of 15 U.S.C. § 80a-35 (1964), dealing with injunctions against gross abuse of trust, even though the section mentions only the Commission in its grant of such a remedy. The court, nevertheless, held that such a right could be implied. (*Contra*, Cogan v. Johnston, 162 F. Supp. 907, 909 (S.D.N.Y. 1958); see note 57 *infra*.) In the first opinion, the court disposed of defenses based upon the fact that the defendant had resigned his position as an officer of the fund, and hence was not an officer of "any registered investment company" as the section seems to require, with the following observation:

We can not charge Congress with an absurdity. . . . Obviously, the fact that the co-defendant was not employed as an officer or director of a registered investment company when this suit was instituted is immaterial to a decision on whether, because of his alleged past violations, an injunction should issue under Section 36. Surely Congress could not have meant to set up an important protection against gross abuse of trust on the one hand and vitiate its effect by providing such an easy route of escape on the other. SEC v. Wong, 254 F. Supp. 66, 69 (D.C.P.R. 1966).

It would seem that the same reasoning should apply to any claim that the entire range of fiduciary duties under the Act does not apply to the unregistered company.

55 See Cogan v. Johnston, 162 F. Supp. 907 (S.D.N.Y. 1958), where, in an action by a shareholder against an unregistered investment company, the court denied a motion to dismiss and held that jurisdiction was properly invoked under section 44 of the Act, 15 U.S.C. § 80a-43 (1964), "which grants to the district court jurisdiction of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, the Act . . ." *Id.* at 909.

56 *E.g.*, SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968).

57 It is at least arguable that the rights of a private party in an injunction action under the Act are more limited than when the plaintiff is the SEC, which is granted specific authority to seek injunctive relief against "gross misconduct or gross abuse of trust." See Investment Company Act of 1940 § 36, 15 U.S.C. § 80a-35 (1964), which authorizes the SEC to bring suit for injunctive relief against gross misconduct and abuse of trust under the Act. Presumably a private party could also seek such relief, subject to the usual requirements of a suit in equity. *Contra*, Cogan v. Johnston, 162 F. Supp. 907 (S.D.N.Y. 1958), where the court sustained a cause of action under section 44 of the Act, 15 U.S.C. § 80a-43 (1964), but went on to state:

The second cause of action is also specifically predicated upon jurisdiction under Section 36. The plain language of that section authorizes the Commission to bring an action against an individual based upon gross abuse of trust in respect of any registered investment company for which such person serves as an officer or director. Whatever relief the plaintiff may be entitled to, he may not, as an individual, sue under this section on the basis of alleged abuse of trust by an officer or director of an unregistered investment company, to enjoin the officer or director from holding his office. *Id.* at 909.

58 *Cf.* Kerr, *supra* note 10, at 36, together with authorities referred to therein, where it is concluded that the limitation of the definition of "value" of the assets of "registered" companies contained in 15 U.S.C. § 80a-2(a)(39) (1964) is equally applicable to unregistered companies.

59 15 U.S.C. § 80a-1(b) (1964), provides:

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z-4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected—

(1) when the investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented,

adoption of the Act, appear to constitute a comprehensive mandate which covers all of the subsequent statutory prohibitions. A careful examination of the Act reveals that each of the detailed proscriptions contained in its other sections has an abbreviated counterpart in section 1(b), and that each is but an implementation of the fiduciary standards which the Act imposes in section 1(b).⁶⁰ When the Act is so considered — and it is submitted that this is the only construction which gives meaning to the obvious purpose of eliminating investment companies that do not adhere to the high standards of conduct which Congress determined to impose—the limitation of the subsequent sections to “registered” companies is rendered purely academic.⁶¹ The application of section 1(b) is not limited to companies which are registered under the Act. It speaks, rather, of “investment companies,” which are defined in section 3(a), and the definition patently is not limited simply to companies which register under the Act.

In addition to the logic of this suggested reading of section 1(b), there is additional support for it in both the statute and in the case law. There is a specific mandate in the last sentence of section 1(b) that the Act “shall be interpreted . . . so far as is feasible, to eliminate the conditions enumerated in this section” and it is also declared that “the policy and purposes” of the Act are to be interpreted with reference to section 1(b). Thus, it appears clear that

concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when the investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves. It is declared that the policy and purpose of this subchapter, in accordance with which the provisions of this subchapter 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.

60 “§ 1(b) of the Act . . . in effect codifies the fiduciary obligations placed upon officers and directors of investment companies.” *Aldred Inv. Trust v. SEC*, 151 F.2d 354, 260 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946). *See also* *Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961); *Lobell, Rights and Responsibilities in the Mutual Fund*, 70 *YALE L.J.* 1258 (1961); *Greene, supra* note 35.

61 *Cf. SEC v. Midland Basic, Inc.*, 283 F. Supp. 609 (D.S.D. 1968), where the court applied the prohibitions of 15 U.S.C. § 80a-9(a) (1964) to a company which was unregistered at the time the suit was commenced, but had subsequently registered to satisfy the demands of the SEC. *Id.* at 614. The court did not discuss the distinction between registered and unregistered companies.

Congress, at least, considered that the various sections would be construed with reference to one another and that it was imposing the same standards upon all investment companies—not just those which subsequently registered. Moreover, the courts have alluded to the last sentence of section 1(b) and held that it constitutes a direction to the courts with respect to the interpretation of the Act.⁶² Finally, in other connections it has been held that a technical reading of the statute may not be indulged in to frustrate its purposes.⁶³

C. Failure to Register and Section 7

A more direct and obvious approach to the liabilities of an unregistered investment company and its management is available under the provisions of section 7.⁶⁴ There is no doubt that section 7, which requires registration pursuant

⁶² *Brown v. Bullock*, 294 F.2d 415, 421 (2d Cir. 1961) (breach of section 1(b) will result in penalties).

⁶³ *Cf. Roth v. Fund of Funds, Ltd.*, 279 F. Supp. 935 (S.D.N.Y. 1968), *aff'd*, 405 F.2d 421 (2d Cir. 1968). *See also SEC v. Midland Basic, Inc.*, 283 F. Supp. 609 (D.S.D. 1968); *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965) (the Act is to be given a liberal construction to accomplish its remedial purposes).

⁶⁴ 15 U.S.C. § 80a-7 (1964) declares:

(a) No investment company organized or otherwise created under the laws of the United States or of a State and having a board of directors, unless registered under section 80a-8 of this title, shall directly or indirectly—

(1) offer for sale, sell, or deliver after sale, by the use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person; or offer for sale, sell, or deliver after sale any such security or interest, having reason to believe that such security or interest will be made the subject of a public offering by use of the mails or any means or instrumentality of interstate commerce;

(2) purchase, redeem, retire, or otherwise acquire or attempt to acquire, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person;

(3) control any investment company which does any of the acts enumerated in paragraphs (1) and (2) of this subsection;

(4) engage in any business in interstate commerce; or

(5) control any company which is engaged in any business in interstate commerce.

The provisions of this subsection shall not apply to transactions of an investment company which are merely incidental to its dissolution.

(b) No depositor or trustee of or underwriter for any investment company, organized or otherwise created under the laws of the United States or of a State and not having a board of directors, unless such company is registered under section 80a-8 of this title or exempt under section 80a-6 of this title, shall directly or indirectly—

(1) offer for sale, sell, or deliver after sale, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security of which such company is the issuer; or offer for sale, sell, or deliver after sale any such security or interest, having reason to believe that such security or interest will be made the subject of a public offering by use of the mails or any means or instrumentality of interstate commerce;

(2) purchase, redeem, or otherwise acquire or attempt to acquire, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security of which such company is the issuer; or

(3) sell or purchase for the account of such company, by use of the mails or by any means or instrumentality of interstate commerce, any security or interest in a security, by whomever issued.

The provisions of this subsection shall not apply to transactions which are merely incidental to the dissolution of an investment company.

(c) No promoter of a proposed investment company, and no underwriter for such a promoter, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale,

to section 8,⁶⁵ applies to any company falling within the definition of section 3(a).⁶⁶ Section 7 simply declares that a company which does not so register shall not engage in certain activities, the scope of which are sufficiently broad to encompass almost any activity of an unregistered investment company, including even engaging in any business in interstate commerce.⁶⁷ The activities of promoters and underwriters⁶⁸ are also included in the proscriptions of section 7. Thus, in many cases in which a shareholder is aggrieved under circumstances where an investment company has failed to register under the Act, it is possible to take direct action under the provisions of section 7 against either the company or its principals, or both.⁶⁹

In any action against an unregistered investment company by an aggrieved stockholder, one of the most important provisions contained in section 7 is the familiar prohibition, included in most securities legislation, that it is unlawful for a company or any other person subject to the Act to sell securities without complying with the registration requirements. While this proposition may appear obvious, it is nevertheless of fundamental importance when considered in conjunction with the voidability provisions.⁷⁰

As we shall see, the voidability provisions of the Investment Company Act apply to the stock sales agreement along with any other business transactions of an unregistered company. The importance of the application of the voidability provisions to the sales contract is found in the incredible simplicity of the remedy for the aggrieved stockholder; for in view of this blanket prohibition against the sale of any stock without registration, the trier of fact in any action based upon section 7 need only address itself to the single question of whether the company was in fact an "investment company"⁷¹ within the meaning of the Act. If the answer to that inquiry is in the affirmative, liability—at least under the voidability concept—would seem to be established without the need of considering matters such as causation, reliance, scienter or the other vestiges of common law fraud

in connection with a public offering, any preorganization certificate or subscription for such a company.

(d) No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer. Notwithstanding the provisions of this subsection and of section 80a-3(a) of this title, the Commission is authorized, upon application by an investment company organized or otherwise created under the laws of a foreign country, to issue a conditional or unconditional order permitting such company to register under this subchapter, and to make a public offering of its securities by use of the mails and means or instrumentalities of interstate commerce, if the Commission finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of this subchapter against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors.

65 *Id.* § 80a-8 (1964).

66 *Id.* § 80a-3(a) (1964).

67 *Id.* § 80a-7(a)(4) (1964).

68 *Id.* §§ 80a-7(b), (c), (d) (1964).

69 See *Cogan v. Johnston*, 162 F. Supp. 907 (S.D.N.Y. 1958). Cf. *Townsend Corp. of America v. Davidson*, 222 F. Supp. 1 (D.N.J. 1963).

70 Investment Company Act of 1940 § 47, 15 U.S.C. § 80a-46 (1964).

71 There may be subsidiary questions, such as who are controlling persons within the meaning of section 48, 15 U.S.C. § 80a-47 (1964), but they do not involve the basic liability concept.

which are frequently injected into actions under the anti-fraud provisions⁷² of other securities laws. Thus, a major battleground in the development of implied liabilities⁷³ might be avoided entirely where Investment Company Act violations are found to occur.

It is incorrect, however, to assume that once a violation of section 7 is established, reference to section 1(b) will therefore be unnecessary, for there may be circumstances in which the shareholder may be anxious to correct practices declared unfair by section 1(b). Since registration is the function and responsibility of management, and not a responsibility of the shareholder that could limit his rights if the registration requirement is not complied with,⁷⁴ an aggrieved shareholder may well prefer to ignore section 7 and proceed directly against management on the ground that there has been a breach of fiduciary obligations under section 1(b). Finally, if a causal relationship is necessary in a damage action based upon a failure to register under section 7,⁷⁵ such a causal relationship may exist between the injury the shareholder has suffered and a breach of the obligations defined in section 1(b).

III. Voidability

Given the cause of action, the remedy selected by a shareholder may vary from case to case. However, in any such case the provisions of section 47(b),⁷⁶

⁷² Securities Act of 1933 § 17, 15 U.S.C. § 77q (1964); Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (1964), together with Rule 10b-5, 17 C.F.R. § 240.10b-5 (1968), implementing section 10.

⁷³ *Compare* Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951), with *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), as to whether proof of "scienter" is necessary in a private action under the anti-fraud provisions of the Securities Exchange Act of 1934. The better view is that neither "scienter" nor any other element of common law fraud should be read into such an action, since they are not among the elements prescribed in the statute or 17 C.F.R. § 240.10b-5 (1968) (Rule 10b-5) adopted by the SEC. See *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965), where the court remarked:

It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact. *Id.* at 379.

Such additional elements are not required when the SEC brings an action to enforce the provisions of the various securities laws, and there is no apparent reason why the stockholder, whom the Act was designed to protect, should be put to a stiffer test. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir.), *petitions for cert. filed*, 37 U.S.L.W. 3255 (U.S. Jan. 14, 1969) (No. 897), 37 U.S.L.W. 3264 (U.S. Jan. 21, 1969) (No. 937), *commented on in* 44 NOTRE DAME LAWYER 252 (1968).

⁷⁴ Note that under the voidability provisions of section 47 of the Act, 15 U.S.C. § 80a-46 (1964), the only rights that are declared void are those of persons in violation of the Act.

⁷⁵ The preferable view is that no causal relationship is required, since the Act prohibits any business transactions in the absence of registration. Under other securities laws it has been held that where a firm proscription is alleged, rather than actual or constructive fraud such as under Rule 10b-5, elements such as reliance or causation need not be shown. *Cf. Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959).

⁷⁶ 15 U.S.C. § 80a-46(b) (1964):

Every contract made in violation of any provision of this subchapter or of any rule, regulation, or order thereunder, and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this subchapter, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or per-

the "voidability" section, will be of importance. That section, simply stated, provides that any contract in violation of the Act or involving the continuance of any relationship or practice in violation of the Act shall be void with respect to the rights of the person in violation. Presumably, in selecting his remedy the person not in violation could elect to preserve his rights under the contract.

In view of the broad proscriptions of sections 1(b) and 7, and in particular the provisions of section 7 dealing comprehensively with sales activities and associated conduct of promoters, underwriters and related functionaries,⁷⁷ it seems clear that, in relation to sales transactions, the voidability provisions should be given literal application for the benefit of any shareholders who claim to have been injured by a breach of the section 7 requirements. Considering the obvious intent of Congress to eliminate unregulated investment companies entirely, and the apparent fact that investors are injured in the same degree by a negligent disregard of the Act as in those cases where the breach is calculated, the voidability provisions should be strictly applied even in the face of contentions by management that the peculiar circumstances of the case warrant a softening of the application of section 47(b). Moreover, because of the special wording of both section 7 and section 47(b), and the general philosophy of the Act, wholly executed agreements appear to be within the contemplation of the voidability provisions. This is contrary to the result which has been reached under related provisions of the Securities Exchange Act of 1934.⁷⁸

Although the admonition of Professor Loss in relation to the voidability concept that "there should be an inquiry in each case to decide whether enforcement or non-enforcement of the contract would better promote the purposes of the statute"⁷⁹ is valid in relation to Investment Company Act violations in general, his assertion that

[w]hen a seller has already delivered the securities in violation of §5,⁸⁰ or after a sale which violates §5 or §17(a), the court may be expected to be somewhat concerned about the general policy ["of preventing people from getting other people's property for nothing when they purport to be buying it"] which was so pungently expressed by Justice Holmes⁸¹

formance of such contract was in violation of any such provision, rule, regulation, or order.

⁷⁷ See notes 67, 68 *supra* and accompanying text.

⁷⁸ Inquiry into whether the non-enforcement of contracts will advance the policy of the laws has led some courts to reject voidability under other securities laws which may be considered *in pari materia*. See *Bankers Life and Cas. Co. v. Bellanca Corp.*, 288 F.2d 784 (7th Cir.), *cert. denied*, 368 U.S. 827 (1961). *Cf. A. C. Frost & Co. v. Coeur d'Alene Mines Corp.*, 312 U.S. 38 (1941), where a contract merely having a relationship to a public offering was held not subject to avoidance as being in violation of the provisions of the Securities Act of 1933. *But see Kaizer-Frazier Corp. v. Otis & Co.*, 195 F.2d 838 (2d Cir.), *cert. denied*, 344 U.S. 856 (1952), holding a similarly related transaction between an issuer and a broker void under section 29(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc(b) (1964). The *Frost* case is distinguishable because (1) it arose under the Securities Act of 1933, which contains no voidability section, and (2) because it did not involve an agreement squarely within the activities the Act was designed to regulate. See Loss, *supra* note 48, at 1797-1805.

⁷⁹ Loss, *supra* note 48, at 1802.

⁸⁰ The reference is to the Securities Act of 1933, 15 U.S.C. § 77e (1964). The counterpart of section 5 of the Securities Act (prohibiting sales without registration) in the Investment Company Act of 1940 is section 7, 15 U.S.C. § 80a-7 (1964). For the text of section 7, see note 64 *supra*.

⁸¹ Loss, *supra* note 48, at 1804, *citing Kelly v. Kosuga*, 358 U.S. 516, 518, 520-21 (1959), *quoting from Continental Wall Paper Co. v. Louis Voigt & Sons Co.*, 212 U.S. 227,

is subject to considerable doubt. Here, it would seem, Congress has clearly declared that where securities are sold in disregard of the registration requirements a statutory policy of non-enforcement, even of fully executed contracts, is in the public interest.

The Investment Company Act is, in its general purport, regulatory in nature.⁸² The distinction between regulatory measures, affecting the continued existence of the company and its relationship with its shareholders, and the concept of disclosure which dominates the other federal securities laws, may be of profound importance in view of the language of section 47(b). That section declares that "every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, [the Act] shall be void"⁸³ (Emphasis added.) By reason of the Act's regulatory provisions, the very existence of the unregistered investment company is a relationship or practice which is proscribed by sections 1(b) and 7 and, therefore, is subject to avoidance according to the plain meaning of section 47(b). While it may be argued with considerable logic that the same result should obtain under a disclosure statute, since the refusal to apply voidability would amount to an inequitable award to the party in violation of the statute of the fruits of his wrongdoing, and hence a continuance of a violation of the law, the case for voidability stands on a stronger footing in the context of a regulatory system.⁸⁴ Therefore, when the issue is presented, the courts will presumably have little difficulty in reading the provisions of section 47(b) broadly enough to affect even fully executed agreements related to sales transactions.⁸⁵

In fact, the scant authorities under the Act indicate that the courts have had no difficulty in reading section 47(b) literally. In *Brown v. Bullock*,⁸⁶ on issues presented by way of preliminary motions, the court held that the voidability provisions could be applied to an investment advisory contract and that the advisor could be required to repay its management fees for years as to which the contract had been fully performed. Presumably, the case never actually went to trial. Provisions of a brokerage agreement entered into by an investment advisor were held void in *Lutz v. Boaz*,⁸⁷ without specific reference to section 47(b). Reasoning that the defendants should not be permitted to profit by a void

271 (1909) (dissenting opinion). See also *Bankers Life and Cas. Co. v. Bellanca Corp.*, 288 F.2d 784 (7th Cir.), cert. denied, 368 U.S. 827 (1961), applying the same rationale to an action under section 29(b) of the Securities Exchange Act of 1934.

82 E.g., *Brown v. Bullock*, 194 F. Supp. 207, 217 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961).

83 15 U.S.C. § 80a-46(b) (1964) (emphasis added). See note 76 *supra*.

84 Cf. *Goldstein v. Groesbeck*, 142 F.2d 422 (2d Cir.), cert. denied, 323 U.S. 737 (1944), where the similar voidability provisions of the Public Utility Holding Company Act, 15 U.S.C. § 79z (1964), were held effective to void fully executed contracts. Significantly, the Holding Company Act is also of a regulatory nature.

85 Cf. *Schwartz v. Bowman*, 156 F. Supp. 361 (S.D.N.Y. 1957), appeal dismissed sub nom. *Schwartz v. Eaton*, 264 F.2d 195 (2d Cir. 1959), where, in a derivative action by a stockholder of a railroad company alleging that certain stock sales by the railroad company to an unregistered investment company were void under section 47 of the Investment Company Act, the court implicitly recognized the voidability concept in disposing of motions to dismiss. Since it was subsequently determined that the court lacked jurisdiction as to the cause of action because of the primary jurisdiction of the Interstate Commerce Commission, the case is questionable authority. Commentators have also read the provision broadly. See *Garrett*, *supra* note 12, at 363.

86 194 F. Supp. 207 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961).

87 171 A.2d 381 (Del. 1961).

contract, the court refused to allow the defendants a set-off for the reasonable value of their services during years in which the unlawful contract had been fully performed and the registered fund had obtained the benefit of the services.⁸⁸

Although one court has held comparable provisions in the Securities Exchange Act of 1934⁸⁹ effective as to executory contracts only,⁹⁰ it is evident from the language of section 7 of the Investment Company Act that voidability under the Act must comprehend fully executed transactions. The provisions of section 7 repeatedly declare that promoters, depositors, trustees, companies or underwriters shall not "sell, or deliver after sale"⁹¹ (emphasis added) any securities issued by an investment company which is not registered. The frequent use of such terms seems to clearly imply fully executed sales agreements. That is not to suggest, however, that a court of equity should not condition recovery upon the plaintiff making restitution of the securities purchased, or similar equitable arrangements.⁹² But if the securities have been disposed of, principles of restitution should not deny an aggrieved shareholder his remedy.⁹³

Conclusion

It is the thesis of this article that sections 1(b) and 7 of the Investment Company Act, when read in conjunction with the voidability provisions of section 47(b), present a potentially useful tool in the assertion of stockholder rights by way of a private cause of action. Where a company which fits the definition of an "investment company" contained in the Act fails to fulfill the requirements of either section 1(b) or 7, counsel for management should be alert to require prompt corrective measures. In similar circumstances, those advising stockholders whose investments have gone sour might find these provisions most useful if the violations of the Act are in connection with investors' loss.

As a vehicle for shareholder action, these provisions of the Investment Company Act appear to present a clear alternative to action under the more familiar anti-fraud provisions of the Securities Act of 1933⁹⁴ and the Securities Exchange Act of 1934,⁹⁵ and an alternative which might profitably be asserted in conjunction with such a fraud claim. Moreover, an action under the Investment Company Act may be preferable to an action under the anti-fraud provisions because of the apparent lack of the necessity to prove any of the elements of com-

88 The investment advisor was, however, permitted to claim actual expenses incurred as a set-off. *Id.* at 391.

89 The language of section 7 may be compared with sections 3(a)(14), 5, 9 and 10 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(a)(14), 78e, 78i and 78j (1964), all of which are at least ambiguous as to whether they contemplate fully executed transactions. There is no apparent reason why they should not reach such agreements, however, at least where the relief sought is consistent with the purpose of the statute. The only case which casts doubt on this proposition is *Bankers Life and Cas. Co. v. Bellanca Corp.*, 288 F.2d 784 (7th Cir.), *cert. denied*, 368 U.S. 827 (1961).

90 *Bankers Life and Cas. Co. v. Bellanca Corp.*, 288 F.2d 784, 787 (7th Cir.), *cert. denied*, 368 U.S. 827 (1961). See also note 78 *supra*.

91 See 15 U.S.C. §§ 80a-7(a)(1), (b)(1), (c), (d) (1964), all of which employ the language quoted.

92 See *Loss*, *supra* note 48, at 1804.

93 *Cf. Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); RESTATEMENT OF RESTITUTION §§ 65, 151, 201, 215 (1937).

94 15 U.S.C. § 77q (1964).

95 *Id.* § 78j and Rule 10b-5 adopted pursuant thereto, 17 C.F.R. § 240.10b-5 (1968).

mon law fraud which have frequently been read into actions under other securities laws.

These concepts were first brought into sharp focus and given effect in the 1968 Court of Appeals for the Tenth Circuit decision of *Esplin v. Hirschi*.⁹⁶ Although the court only addressed itself briefly to the Investment Company Act, it did so in a manner that clearly indicated its intention to adopt the position that a private action may be based upon section 7 and the voidability provisions of the Act:

This court, therefore, finds that although the Investment Company Act makes no specific provision for private civil liability arising from the violations of the Act such liability may be implied.

The court below in its conclusions of law found that B & E was at all times after July 1, 1961, an unlicensed investment company within the definition, meaning and intent of the Act. Hence, the cause of action against B & E should have been sustained⁹⁷ and the requested rescission of the security purchase arrangement allowed. This conforms with the provisions of the Act declaring any contracts made by an investment company in violation of the Act (including the sale of unregistered securities) to be void.⁹⁸

Thus the voidability section was given literal effect, and in this case applied to a fully executed, verbal agreement.

In another connection, while disposing of the question whether the case should be maintained as a class action under the provisions of amended Rule 23,⁹⁹ the *Hirschi* court examined the elements of such an action and squarely adopted the simplified formula advanced herein which the Act seems to require:

Inasmuch as plaintiffs were merely required to show that B & E was an investment company, that it had not registered and that the individual defendants were controlling persons, the activities of the plaintiffs could have little or no effect upon the operative facts determining liability. Hence, while the propriety of allowing a class action on the 10b-5 count is an extremely close question, there is really little doubt, as to the Investment Company Act, that the common issues predominate.¹⁰⁰

Significantly, each of these propositions (except as to the Rule 23 class action)

⁹⁶ 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 37 U.S.L.W. 3369 (U.S. April 1, 1969) (No. 1013).

⁹⁷ The trial court did not grant relief under the Investment Company Act claim because of its conclusion that the claim was barred by the applicable statute of limitations. The appellate court differed with that conclusion and held that "[i]n any event, the federal law clearly requires that in every limitation question the old chancery doctrine of equitable tolling is to be applied" and that after applying the tolling doctrine the claim was within the applicable limitation period. *Esplin v. Hirschi*, 402 F.2d 94, 103 (10th Cir. 1968), *cert. denied*, 37 U.S.L.W. 3369 (U.S. April 1, 1969) (No. 1013).

⁹⁸ *Id.* at 103-04.

⁹⁹ FED. R. CIV. P. 23.

¹⁰⁰ *Esplin v. Hirschi*, 402 F.2d 94, 99 (10th Cir. 1968), *cert. denied*, 37 U.S.L.W. 3369 (U.S. April 1, 1969) (No. 1013).

was also recognized in the trial court,¹⁰¹ and apparently is no longer disputed even by the defendants.¹⁰²

Thus, while *Hirschi* may constitute an important precedent with respect to the liabilities of companies and their management which either intentionally or negligently fail to adhere to the standards imposed by the Act, it is evident that to effectively test the limits of these concepts further case development will be desirable. Such development is long overdue. Hopefully, the practicing bar will pay greater attention to this type of private action. The clear invitation of Congress for investors in unregistered investment companies to avail themselves of self-help, by way of a private civil action, and to require compliance with the regulatory scheme is certainly an alternative which merits more attention than it has received in the twenty-nine years since the Act was adopted.

101 *Hirschi v. B & E Securities, Inc.*, Civil No. C 243-65 (D. Utah, Aug., 1966). The trial court found, based upon the single determination of the jury that "B & E Securities, Inc., engaged or proposed to engage primarily in the business of investing, reinvesting or trading in securities at any time from its organization through the time of the sale of stock to plaintiffs," that "B & E Securities, Inc., was . . . an unlicensed 'investment company' within the definition, meaning and intent of the Investment Company Act of 1940" Accordingly, it declined to require a showing of causation, reliance or any other elements frequently required in actions under the anti-fraud provisions of the securities laws.

102 The defendants in *Hirschi* apparently now concede that liability may be properly invoked under the Investment Company Act. In their petition for certiorari filed with the United States Supreme Court they assert:

The court of appeals ruled that the proper statute had been applied to your petitioners and sustained the dismissal of the Investment Company claim as to them, but held that B & E was liable under the Investment Company Act because a different limitations statute was applicable to it. This ruling is not questioned by this Petition. Petitioner's Brief for Certiorari at 18-19, *Esplin v. Hirschi*, Docket No. 1013, Supreme Court of the United States, Jan., 1969.