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# Daily Income Fund, Inc. v. Fox: A Door to the Federal Courts Opens Needlessly

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# ***Daily Income Fund, Inc. v. Fox: A Door to the Federal Courts Opens Needlessly***

## **I. Introduction**

In *Daily Income Fund, Inc. v. Fox*,<sup>1</sup> the United States Supreme Court held that an action brought under section 36(b) of the Investment Company Act (ICA or Act)<sup>2</sup> is not a derivative

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1. 104 S. Ct. 831 (1984).

2. Section 36(b) provides in relevant part:

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) [original section 36 of the 1940 Act] of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

15 U.S.C. § 80a-35(b) (1976).

action and, therefore, plaintiff shareholders need not comply with the demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure.<sup>3</sup> The Supreme Court's decision, affirming the Second Circuit,<sup>4</sup> resolved a conflict among the circuit courts.<sup>5</sup>

As a result of the Supreme Court's decision, shareholders of mutual funds<sup>6</sup> need not make a demand on the directors of the fund when challenging the reasonableness of advisory fees under section 36(b) of the ICA. Although the Court's decision was unanimous and, perhaps, uncontroversial, it unnecessarily provides shareholders with unbridled access to the federal courts to seek judicial review of management decisions. Eliminating the demand requirement shifts the initial forum for such challenges from the corporate boardroom to the courtroom and deprives the fund's management of the *opportunity* to seek a solution without costly and protracted litigation.<sup>7</sup>

This Note examines the Court's conclusion in light of the extensive legislative history surrounding the enactment of section 36(b). To provide an adequate framework for that examination, Part II of this Note reviews the historical development of the mutual fund industry and the legislative proposals enacted

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3. Rule 23.1 provides in pertinent part:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation . . . , the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and the reasons for his failure to obtain the action or for not making the effort.

FED. R. CIV. P. 23.1.

4. *Fox v. Reich & Tang, Inc.*, 692 F.2d 250 (2d Cir. 1982).

5. See *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d 928 (3d Cir. 1982), *vacated and remanded*, 52 U.S.L.W. 3550 (U.S. Jan. 23, 1984) (No. 82-1592); *Grossman v. Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, 103 S. Ct. 85 (1982). See *infra* notes 88-98 and accompanying text (both circuits found that Rule 23.1 was applicable to § 36(b) suits).

6. The term mutual fund is commonly used to designate the open-end investment company. The mutual fund shareholder owns a proportionate share of the fund's pooled assets. *Fox*, 104 S. Ct. at 831. For a detailed description of investment companies, see WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 37-49 (1962) [hereinafter cited as WHARTON REPORT].

7. Any recovery from a § 36(b) action goes directly to the fund and not the shareholders. *Markowitz v. Brody*, 90 F.R.D. 542, 560-61 (S.D.N.Y. 1981). For an example of the high cost of § 36(b) actions, see *Krasner v. Dreyfus Corp.*, 90 F.R.D. 665, 672-73 (S.D.N.Y. 1981) (\$2.82 million settlement of a § 36(b) claim).

to guide its development. Part III presents the facts of the case, the opinion of the Court, and Justice Stevens' concurring opinion. Part IV traces the unclear and conflicting legislative history of section 36(b) and suggests that the Court failed to consider the complete history in light of its own decisions regarding the implication of private rights of action under federal statutes. The Note concludes that the demand requirement is relevant and necessary to the management of mutual funds and does not act as a deterrent to shareholders' legitimate complaints regarding excess adviser fees.

## II. Background

### A. *Mutual Funds*

Mutual funds first came into existence in 1924.<sup>8</sup> The funds are owned by small investors who pool their resources to have professional money managers invest their shares in a variety of securities.<sup>9</sup> The shareholders thus receive the benefits of large scale investing while depositing only small sums of money.<sup>10</sup>

Mutual funds are typically organized by investment management companies, usually called investment advisers,<sup>11</sup> which provide professional investment advice.<sup>12</sup> The investment adviser appoints the first board of directors of a newly formed corporate fund.<sup>13</sup> That board then enters into a contract<sup>14</sup> with one

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8. WHARTON REPORT, *supra* note 6, at 4.

9. *Id.* at 7-9.

10. *Weiss v. Temporary Inv. Fund, Inc.*, 516 F. Supp. 665, 666 (D. Del. 1981). This basic concept reflects the fact that mutual fund shareholders are proportionate owners of the total portfolio of the fund. These shareholders may be able to own a percentage of a certain investment they might otherwise be unable to afford. WHARTON REPORT, *supra* note 6, at 7.

11. S. REP. NO. 184, 91st Cong., 1st Sess. 5, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901. The statutory definition of an investment adviser is contained in 15 U.S.C. § 80a-2(19) (1970).

12. REPORT OF THE SECURITIES & EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 46-47 (1966) [hereinafter cited as PUBLIC POLICY REPORT].

13. WHARTON REPORT, *supra* note 6, at 66-68. "The investment adviser usually is well represented on the fund's board of directors and maintains effective control over the fund." *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 10 (1967) (statement of M. Cohen, SEC Chairman).

14. WHARTON REPORT, *supra* note 6, at 66. The ICA requires that a written contract exist between the adviser and the fund. 15 U.S.C. § 80a-15(a) (1976). The contract is

or more third parties who will manage the fund and provide investment services. In most cases, the party with whom the board contracts to provide these services is the same investment adviser who appointed the board.<sup>15</sup> In return for its services, the adviser receives a fee — traditionally one-half of one percent of the net asset value of the fund.<sup>16</sup> In addition to its fee for management and investment services, the investment adviser may receive underwriting fees or brokerage commissions, if it also serves in those capacities.<sup>17</sup>

A mutual fund is characterized by the close relationship between the investment adviser, which creates the corporation and appoints its board, and the board, which contracts with the adviser for management services.<sup>18</sup> The management of a mutual fund is distinguished by its reliance on third party, or “externalized,” management.<sup>19</sup> This interrelationship gives rise to an inherent overlapping of functions and provides the potential for several conflicts of interest between the investment adviser and the board.<sup>20</sup>

required to specify “precisely” the adviser’s compensation and must allow the fund the right to revoke the contract without penalty, upon 60 days written notice. *Id.* § 80a-15(a)(1), (3). Additionally, contracts for more than two years must be approved yearly by the board or shareholders. *Id.* § 80a-15(a)(2).

15. WHARTON REPORT, *supra* note 6, at 66-67.

16. PUBLIC POLICY REPORT, *supra* note 12, at 89.

17. “There have been three principal and interrelated sources of income and other benefits that accrue to investment advisers . . . maintaining effective control over mutual funds: (1) advisory and management fees; (2) payments for selling activities in the wholesale and retail distribution of mutual fund shares [underwriting]; and (3) brokerage commissions . . . .” WHARTON REPORT, *supra* note 6, at 28. The Report indicated that management fees were the largest single source of gross income to the advisers, ranging from 47.2% to 88.3%. *Id.*

18. *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., 10 (1967) (statement of SEC Chairman M. Cohen).

19. “This ‘externalization of management’ is the most striking feature of the industry’s organizational pattern.” PUBLIC POLICY REPORT, *supra* note 12, at 45. Explaining this characteristic further, the Report stated:

The practice of buying investment advice and management from an external adviser is one of long standing and was firmly imbedded in the industry at the time that the Act [ICA] was under consideration. The Act permitted it to continue. . . . [E]xternal management remains predominant even in the case of the largest funds whose resources are clearly large enough to permit them to establish efficient, well staffed, and well-remunerated advisory departments of their own.

*Id.* at 49-50.

20. *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 130 (1967) (statement of SEC Chairman M. Cohen).

Specifically, conflicts can occur in the negotiation of advisory fee contracts and in situations where the adviser serves as a broker. In negotiating the fee, the fund directors face the competing and conflicting interests of the adviser and the fund shareholders.<sup>21</sup> The adviser, which appointed the directors, seeks a high fee while the shareholders want a low fee to maximize their return on investment. Similarly, an adviser serving as a broker has the incentive to increase its fee through frequent portfolio transactions, since brokerage commissions are based on the number of transactions completed.<sup>22</sup> The transactions may or may not be in the shareholders' best interest, but *any* transaction is in the interest of the adviser as broker. Thus, from their inception through the 1930's, mutual funds were plagued with abuses that resulted from their structure and accompanying conflicts of interest.<sup>23</sup>

## B. *The Investment Company Act*

### 1. *Statutory history*

The Investment Company Act of 1940<sup>24</sup> was enacted to minimize the conflicts arising from the structure of the investment companies as they existed in the early 1930's.<sup>25</sup> The primary purpose of the ICA was to curb abuses and restore confidence in investment companies<sup>26</sup> by preventing the intense self-dealing which was characteristic of the industry.

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21. Because the fund is so closely tied to the investment adviser, *see supra* notes 11-15 and accompanying text, the directors will be less likely to bargain in the marketplace. WHARTON REPORT, *supra* note 6, at 29-30. "These findings suggest that the special structural characteristics of this industry . . . tend to weaken the bargaining position of the fund in the establishment of advisory fees rates." *Id.* at 30.

22. WHARTON REPORT, *supra* note 6, at 32-33. This could work to the disadvantage of the shareholder where the "extensive use of brokerage for rewarding dealers . . . raises the question of whether there is a return of value to the shareholders in this type of arrangement." *Id.* at 33.

23. *Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency*, 76th Cong., 3d Sess. 37-38 (1940).

24. Investment Company Act of 1940, ch. 686, 54 Stat. 789 (current version at 15 U.S.C. §§ 80a-1 to -52 (1976)).

25. S. REP. No. 184, 91st Cong., 1st Sess. 4, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901.

26. *See* *Burks v. Lasker*, 441 U.S. 471, 482 (1979) (noting that the ICA was an effort to control conflicts of interest within the mutual fund industry).

To accomplish this goal, the ICA introduced several procedures intended to eliminate self-dealing. First, at least forty percent of the fund's directors and the adviser had to be unaffiliated with the fund as defined by the Act.<sup>27</sup> Second, the Act prohibited most transactions in securities and other property between the investment company and its adviser or affiliated persons.<sup>28</sup> Third, all advisory contracts had to be approved by the directors or by a majority of the voting shareholders of the fund.<sup>29</sup>

These restrictions seemed to work well for a time since most complaints regarding mutual funds were resolved without litigation.<sup>30</sup> Nevertheless, with the rapid growth of the mutual fund industry,<sup>31</sup> shareholder dissatisfaction with advisory fee arrangements became more intense.<sup>32</sup> Most of the dissatisfaction stemmed from the inequities of the fee arrangement. Whereas the per transaction cost of administering a fund would be expected to fall based on the economies of scale of a larger fund,<sup>33</sup> the traditional flat rate percentage arrangement<sup>34</sup> increased the adviser's fee without a corresponding increase in management burden.

The challenges<sup>35</sup> to the fees were brought under section 36

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27. 15 U.S.C. § 80a-10(a) (1976).

28. *Id.* § 80a-17(a)(1).

29. *Id.* § 80a-15a. See *supra* note 14 and accompanying text.

30. See, e.g., Note, *Private Rights of Action Against Mutual Fund Investment Advisers: Amended Section 36 of the 1940 Act*, 120 U. PA. L. REV. 143, 147-48 (1971).

31. The bare statistics of the funds' growth from 1940 to 1960 are astronomical. The net asset value of American mutual funds rose from less than \$500 million in 1940 to over \$17 billion in 1961. See Eisenberg & Phillips, *Mutual Fund Litigation — New Frontiers for the Investment Company Act*, 62 COLUM. L. REV. 73, 74 (1962).

32. In 1959 and during the next several years, more than 50 lawsuits involving adviser compensation were filed against some of the largest funds in the country. Eisenberg & Phillips, *supra* note 31, at 74. The drafters of the act must have realized this and provided for this contingency in § 14(b), 15 U.S.C. § 80a-14(b) (1976), which authorized the SEC to make studies on the industry from time to time as it deemed necessary and to report its findings to Congress. S. REP. NO. 184, 91st Cong., 1st Sess. 3-4, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4900.

33. S. REP. NO. 184, 91st Cong., 1st Sess. 4, 6, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4902.

34. See *supra* note 16 and accompanying text.

35. See, e.g., *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), cert. denied sub nom. *Johnson v. Moses*, 404 U.S. 994 (1971); *Tanzer v. Huffines*, 314 F. Supp. 189 (D. Del. 1970).

of the ICA which provided for court review of advisory contracts under a standard of "gross misconduct or a gross abuse of trust."<sup>36</sup> This standard imposed a significant burden on a plaintiff shareholder to show that no reasonable board of directors could have agreed to the contract absent a high degree of self-interest.<sup>37</sup> As a result of this almost insurmountable burden, shareholders lacked a satisfactory means to effect judicial review of fees.<sup>38</sup>

In keeping with the mandate of the ICA<sup>39</sup> and in response to the inadequacy of judicial review of the reasonableness of advisory fees,<sup>40</sup> the Securities and Exchange Commission (SEC) authorized a study by the Wharton School of Finance and Commerce.<sup>41</sup> The major conclusion of the study was that unaffiliated directors<sup>42</sup> were "of restricted value as an instrument for providing effective representation of mutual fund shareholders."<sup>43</sup> In addition to the Wharton Report, the SEC conducted its own study regarding the state of the mutual fund industry.<sup>44</sup> Its study concluded that lawsuits initiated under the old standards of section 36 had been largely ineffective due to the standard imposed on the courts to judge the fees.<sup>45</sup> In response to these

36. Section 36 of the 1940 Act stated:

The Commission is authorized to bring an action in the proper district court of the United States or United States Court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after the enactment of this title and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so served or acts . . . .

Investment Company Act of 1940, ch. 686, § 36, 54 Stat. 789, 841 (current version at 15 U.S.C. § 80a-35(a) (1976)).

37. See *Saxe v. Brady*, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (1962).

38. "Shareholder resorts to the courts in connection with advisory fees [have] been relatively ineffective in dealing . . . [with] mutual funds and their investment advisers." PUBLIC POLICY REPORT, *supra* note 12, at 141.

39. See *supra* note 32 and accompanying text (regarding the SEC's power to authorize studies).

40. See *supra* notes 35-39 and accompanying text.

41. WHARTON REPORT, *supra* note 6. This study was transmitted to Congress as the *Wharton Report* in August 1962.

42. 15 U.S.C. § 80a-2(a)(3) (1976) (defining the term affiliated director).

43. WHARTON REPORT, *supra* note 6, at 34.

44. PUBLIC POLICY REPORT, *supra* note 12, at v-vi. This study reached Congress in December 1966.

45. *Id.* at 11. See *supra* notes 36-39 and accompanying text for a discussion of the



studies, Congress enacted several amendments to the ICA.<sup>46</sup>

## 2. *The 1970 amendments*

The amended section 36 of the ICA substantially incorporated the prior section 36 into the present section 36(a).<sup>47</sup> The section, as amended, is intended to ease the burden imposed under section 36 for challenging investment advisory fees.<sup>48</sup> This was accomplished by eliminating the standard of "gross misconduct or a gross abuse of trust";<sup>49</sup> in its place section 36(a) imposes a *fiduciary duty*<sup>50</sup> on the investment adviser and its

burden of proof imposed on shareholders.

46. S. REP. NO. 184, 91st Cong., 1st Sess. 2, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4901. The three primary objectives of the amendments were: first, to amend these sections of the ICA which pertained to investment company management fees; second, to amend sections of the laws dealing with banks and savings institutions; and last, to improve the administration and enforcement of the acts. *Id.*

47. Section 36(a) reads in pertinent part:

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

15 U.S.C. § 80a-35(a) (1976). *Cf.* Investment Company Act of 1940, ch. 686, § 36, 54 Stat. 789, 841. *See supra* note 36.

48. *See supra* notes 36-38 and accompanying text.

49. Investment Company Act of 1940, ch. 686, § 36, 54 Stat. 789, 841. *See supra* note 36.

50. The fiduciary duty standard was a compromise reached between the SEC and the mutual fund industry. The original proposal by the SEC recommended a standard of reasonableness, which was incorporated into the bills submitted to the House and Senate in 1967. H.R. 9510, § 8(d), 90th Cong., 1st Sess. 8 (1967). The mutual fund industry vehemently opposed the standard, contending that the fees were already reasonable and that this new standard would lead to the institution of strike suits. *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. pt. 1 at 197, 201 (1967). The discussions between the SEC and the industry continued, with a basic agreement that the "gross misconduct" standard was unduly restrictive and needed to be changed. PUBLIC POLICY REPORT, *supra* note 12, at 12-14. Finally, an agreement was reached to set a fiduciary duty standard, although that term was never defined. S. 2224, § 20, 91st Cong., 1st Sess. (1969). For a further discussion of the area, see Note, *supra* note 30, at 150-54.

affiliates.<sup>51</sup>

Further, section 36(b) expressly provides that an action for a breach of fiduciary duty may be brought by the SEC or a security holder on behalf of the investment company against the investment adviser or any other person named as having a fiduciary duty arising out of the receipt of compensation for advisory services.<sup>52</sup> The amendment was not a reflection that the fees were too high; its purpose was merely to specify the standard to which the adviser would be held in fulfilling his fiduciary duty and to provide for court enforcement under that standard.<sup>53</sup> Section 36(b) vests the federal courts with exclusive jurisdiction for actions arising under that section.<sup>54</sup> This jurisdictional grant, while intended to establish a means of enforcement, was not designed to authorize a court to substitute its business judgment for that of a mutual fund's board of directors in the area of management fees.<sup>55</sup> In response to congressional concern

51. In addition to the investment adviser, the following are also governed by the fiduciary duty standard: any officer, director, advisory board member or depositor, or principal underwriter of the investment company. 15 U.S.C. § 80a-35(b) (1976).

52. *Id.* See *supra* note 2 for the text of § 36(b).

53. S. REP. No. 184, 91st Cong., 1st Sess. 6, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4902. The *Report* states:

Your committee recognizes the fact that the investment adviser is entitled to make a profit. Nothing in the bill is intended to imply otherwise or to suggest that a "cost-plus" type of contract would be required. It is not intended to introduce general concepts of rate regulation as applied to public utilities. . . .

. . . .  
This section therefore should not be taken as reflecting any finding by the committee that the present industry level of management fees or that the fee of any particular adviser is too high. Its sole purpose is to specify the fiduciary duty of the investment adviser with respect to compensation, and provide a mechanism for court enforcement of this duty.

*Id.*

54. 15 U.S.C. § 80a-35(b)(5) (1976)

55. S. REP. No. 184, 91st Cong., 1st Sess. 6-7, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4902-03. The *Report* states:

The directors of the mutual fund, like directors of any other corporation will continue to have a fiduciary duty to the fund with respect to their own compensation, and, of course, will continue to have overall fiduciary duties as directors for the supervision of all of the affairs of the fund. . . .

. . . .  
. . . . Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the re-

that the judiciary might usurp the role of the directors, the drafters included section 36(b)(2).<sup>56</sup> Section 36(b)(2) provides that a court, in making its determination regarding the reasonableness of the adviser's fee, should give as much consideration "as [it] deems necessary under all the circumstances" to the fact that the board of directors approved the investment adviser's compensation contract.<sup>57</sup> It was the intent of the drafters that a responsible determination by the board regarding management fees was not to be ignored by the courts.<sup>58</sup>

### 3. *Implied causes of action and judicial interpretations under the ICA*

#### a. *Supreme Court decisions*

Supreme Court decisions prior to *Daily Income Fund, Inc., v. Fox*<sup>59</sup> had not directly involved the question of whether a mutual fund has an implied cause of action under the ICA. The Court has, however, developed a considerable body of case law regarding implied causes of action under federal statutes.

In 1964, the Court in *J.I. Case Co. v. Borak*,<sup>60</sup> recognized a private cause of action under a federal statute which did not expressly provide for one. The Court held<sup>61</sup> that a private cause of action could be implied to effectuate the congressional purposes of section 14(a) of the Securities Exchange Act of 1934.<sup>62</sup>

Eleven years later, in *Cort v. Ash*,<sup>63</sup> the Court enumerated four factors to be used in determining whether a private cause of action should be implied from a statute not expressly providing one. The four factors were:

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sponsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.

*Id.*

56. 15 U.S.C. § 80a-35(b)(2) (1976). *See supra* note 2.

57. 15 U.S.C. § 80a-35(b)(2) (1976). *See supra* notes 14, 29 and accompanying text regarding adviser contract approval.

58. S. REP. NO. 184, 91st Cong., 1st Sess. 6, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4903.

59. 104 S. Ct. 831 (1984).

60. 377 U.S. 426 (1964).

61. *Id.* at 430-31.

62. *Id.* at 432-33 (citing 15 U.S.C. § 78n(a) (1976)).

63. 422 U.S. 66 (1975).

- (1) whether the plaintiff is one of the class for whose especial benefit the statute was enacted;
- (2) whether there is an indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one;
- (3) whether it is consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff;
- (4) whether the cause of action is one traditionally relegated to state law.<sup>64</sup>

The Court has since refined its analysis under *Borak* and *Cort*; the inquiry now turns on "whether Congress *intended* to create, either expressly or by implication, a private cause of action."<sup>65</sup> Recently, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*,<sup>66</sup> the Court examined a provision of the Commodities Exchange Act which expressly provided for a right of action by the SEC. In finding that a private right of action existed in the corporation, the Court stated that:

In determining whether a private cause of action is implicit in a federal statutory scheme . . . the initial focus must be on the state of the law *at the time the legislation was enacted*. . . . When Congress acts in a statutory context *in which an implied private right has already been recognized by the courts* . . . the question then is *whether Congress intended to preserve the pre-existing remedy*.<sup>67</sup>

The Court determined that a review of the legislative history of the statute prior to the amendment indicated that an implied right of action was "uniform and well understood."<sup>68</sup> Therefore, since there was no clear indication that Congress intended to negate the prior remedy, the amendments were intended to augment and not to replace that remedy.<sup>69</sup> Presumably, this guiding

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64. *Id.* at 78.

65. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 575 (1979) (emphasis added). See also *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979). The Court in *Transamerica* concluded that the intent of Congress was the most important consideration to review. *Id.* at 15-16.

66. 456 U.S. 353 (1982). The Court was reviewing § 4(b) of the Commodities Exchange Act, 7 U.S.C. § 6(b) (1976), which had been subjected to amendment following its enactment.

67. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. at 378-79 (emphasis added) (footnotes omitted).

68. *Id.* at 380.

69. *Id.* at 394-95.

principle would be relevant to the inquiry of whether Congress intended an implied cause of action under the ICA.

b. *Private cause of action under pre-amendment section 36*

Prior to the 1970 amendments to the ICA, in *Brown v. Bullock*,<sup>70</sup> the Second Circuit recognized the mutual fund's private right of action under section 36 to challenge the reasonableness of the advisory fee.<sup>71</sup> In *Brown*, the court addressed the issue of whether Congress had implicitly precluded an action by the fund under section 36 by expressly authorizing the SEC to challenge fees.<sup>72</sup> The lower court had rejected this argument, reasoning that Congress had clearly intended to protect the investment company, as well as its investors, and that in so doing it empowered the fund itself to enforce its rights in a "private action."<sup>73</sup> The Second Circuit, in affirming the district court, implicitly endorsed its conclusion that the fund was entitled to challenge adviser fee arrangements.<sup>74</sup>

In *Burks v. Lasker*,<sup>75</sup> the Supreme Court, although not directly deciding the issue, implicitly acknowledged the fund's right to bring suit.<sup>76</sup> In *Burks*, the Court was called upon to decide whether the disinterested directors of an investment company could terminate shareholder derivative suits brought against other directors under the Investment Advisers Act (IAA)<sup>77</sup> and the ICA.<sup>78</sup> The Court held that Congress had not

70. 194 F. Supp. 207 (S.D.N.Y.), *aff'd on other grounds*, 294 F.2d 415 (2d Cir. 1961).

71. *Id.* at 236-40. Section 36, prior to its amendment, expressly authorized an action by the SEC. Nevertheless, the Second Circuit found an implied right of action in the fund. *Id.* See also *supra* notes 46-51 and accompanying text (concerning the original § 36 and its subsequent amendments).

72. *Brown v. Bullock*, 194 F. Supp. at 245.

73. *Id.*

74. *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961).

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

76. *Id.* at 475-76.

77. 15 U.S.C. § 80a-35 (1976). The Investment Advisers Act (IAA) was one of six companion statutes enacted at the time of the ICA. In deciding the issue before the Court in *Burks*, Justice Brennan noted the following concerning the independent director:

Congress consciously chose to address the conflict-of-interest problem through the Act's independent-directors section, rather than through more drastic remedies such as complete disaffiliation of the companies from their advisers. . . . Congress

intended to impose a "flat rule that directors may never terminate non-frivolous derivative actions involving co-directors."<sup>79</sup> In deciding the issue of the directors' ability to terminate the shareholder action as an exercise of its business judgment, the Court accepted in dicta that the shareholder had "implied, derivative causes of action under the ICA and IAA."<sup>80</sup>

*c. Post-amendment decisions and Rule 23.1 demand requirement*

Subsequent to the 1970 amendments to section 36 of the ICA, the circuit courts consistently accepted the Second Circuit's conclusion, and the Supreme Court's implicit endorsement, that the mutual fund possessed an implied cause of action under section 36 to challenge advisory fees.<sup>81</sup> Most recently, the

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entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders. . . . [I]t would have been paradoxical for Congress to have been willing to rely largely upon "watchdogs" to protect shareholder interests and yet, where the "watchdogs" have done precisely that, require that they be totally muzzled.

*Burks v. Lasker*, 441 U.S. at 483-85 (footnotes omitted).

78. 15 U.S.C. § 80a-35 (1976). In response to the suit by the shareholders, the board of directors formed a committee of disinterested directors to evaluate the merits of the claim and determined that, in the best interest of the shareholders, it should move for dismissal of the action. *Burks v. Lasker*, 441 U.S. at 474. The district court agreed, reasoning that the business judgment rule permitted the directors to terminate litigation not in the fund's best interest. *Id.* at 474-75. See *infra* note 80 for a discussion of the business judgment rule.

79. *Burks v. Lasker*, 441 U.S. at 481-82.

80. *Id.* at 475-76. The business judgment rule discussed in *Burks* is a rule of corporation law which immunizes management from liability for actions taken within their corporate powers, and involves the exercise of due care and compliance with their fiduciary duty. See H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 242 (2d ed. 1970).

The test established in *Burks* for termination of a shareholder suit by the directors was: (1) whether state law permitted the disinterested directors to terminate the action; and (2) whether the state termination rule was consistent with the federal policy behind the appropriate section of the ICA. *Burks v. Lasker*, 441 U.S. at 480. For a thorough discussion of the business judgment rule and the *Burks* decision, see generally Note, *Termination of Section 36(b) Actions by Mutual Fund Directors: Are the Watchdogs Still the Shareholders' Best Friends?*, 50 FORDHAM L. REV. 720 (1982).

81. The *Burks* Court, referring to *Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961), noted: "Other Courts of Appeals have agreed with the Second Circuit that the ICA and IAA create private causes of action." *Burks v. Lasker*, 441 U.S. at 476 n.5. The Court cited the following cases as authority for the existence of private causes of action

First and Third Circuits have addressed the question of the fund's implied cause of action in the context of shareholder suits under section 36(b).<sup>82</sup> The First and Third Circuits concluded that the existence of a fund's action qualified a shareholder's action as *derivative* and, therefore, a shareholder had to make a demand on the board of directors pursuant to Rule 23.1 of the Federal Rules of Procedure.<sup>83</sup>

i. *Rule 23.1 demand requirement*

Under Rule 23.1, the shareholder bringing a derivative action must show that a demand was made on the company's board of directors prior to his filing the complaint or state in the complaint why the demand would be futile.<sup>84</sup> The predecessor to the current Rule codified a Supreme Court decision which created the requirement that a demand should be made upon the board prior to bringing suit.<sup>85</sup>

The demand requirement under Rule 23.1 serves several important functions. It allows the directors to perform their role by correcting problems presented internally, rather than by pro-

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under the ICA: *Moses v. Burgin*, 445 F.2d 369, 373 (1st Cir. 1971); *Hirpich v. Wallace*, 430 F.2d 792, 815 (5th Cir. 1970); *Esplin v. Hirschi*, 402 F.2d 94, 103 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969); *Taussig v. Wellington Fund, Inc.*, 313 F.2d 472, 476 (3d Cir.), *cert. denied*, 374 U.S. 806 (1963).

82. *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d 928 (3d Cir. 1982), *vacated and remanded*, 52 U.S.L.W. 3550 (U.S. Jan. 23, 1984) (No. 82-1592) (the case was remanded to the Third Circuit to consider it in light of *Fox*); *Grossman v. Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, 103 S. Ct. 85 (1982).

83. *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d at 930; *Grossman v. Johnson*, 674 F.2d at 118, 126.

84. FED. R. CIV. P. 23.1. See *supra* note 3 for the text of Rule 23.1.

85. See *Hawes v. City of Oakland*, 104 U.S. 450 (1881). The Court listed four situations in which a shareholder may bring a derivative action. There must have been: (1) some action by the board which was beyond the corporation's authority by charter; (2) a fraudulent transaction by the board which would result in serious injury to the corporation or the shareholders; (3) some illegal action by a majority of the shareholders in the corporate name, which violates the minorities' rights; or (4) some action by a majority of the board, acting in their own self interest, which is destructive of the corporation or the rights of the other shareholders. In addition, the shareholder must show that he/she has exhausted all intercorporate remedies available. If unable to obtain relief from the board through a concerted effort, the shareholders must be able to show why they were unable to obtain that relief. *Id.* at 460-61. The *Fox* Court discussed the *Hawes* decision and its subsequent codifications leading to the enactment of Rule 23.1. See *Fox*, 104 S. Ct. at 836 n.5.

tracted litigation.<sup>86</sup> The initial demand on the directors also allows them the chance to review the issues presented and either assume control of meritorious actions or cut off frivolous suits brought solely for their settlement value.<sup>87</sup>

ii. *Grossman v. Johnson and Weiss v. Temporary Investment Fund, Inc.*

In *Grossman v. Johnson*,<sup>88</sup> decided seven months prior to *Fox*, the First Circuit held that in enacting section 36(b), Congress neither repealed nor limited the demand requirement, and that an allegation of the directors' acquiescence in setting the fees was insufficient to excuse the requirements of the Rule. The court concluded that the express language of section 36(b), providing that an action be brought *on behalf of such company*, normally indicates that the action is in fact derivative in nature.<sup>89</sup> After reviewing the extensive legislative history of the statute, the court concluded that Congress had not intended to repeal or limit the demand provision of Rule 23.1.<sup>90</sup>

The court also addressed the plaintiff shareholders' contention that a demand on the board of an investment company was a futile exercise and, therefore, the requirement to make the demand should be eliminated.<sup>91</sup> The court noted that in adding section 36(b), Congress deliberately strengthened the role of the independent directors in their dealings with adviser fee arrangements.<sup>92</sup>

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86. *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d at 940-41.

87. See Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 172 (1976).

88. 674 F.2d 115 (1st Cir. 1982).

89. *Id.* at 120.

90. *Id.* at 121-22. The court also noted the fact that no provision restricted the funds use of § 36(b): "We cannot believe, however, that, for example, a new and independent board of directors, intent on recovering excessive fees . . . would be precluded from suing under section 36(b)." *Id.* at 120 (footnotes omitted). The court noted the substantial benefits to the directors which § 36(b)(1) provided, "expressly, remov[ing] the need to allege or prove 'personal misconduct' on the part of any defendant." *Id.* at 120 n.8. This makes it easier for the board to commence the action. *Id.*

91. *Id.* at 121.

92. *Id.* The court noted that the Supreme Court had dealt with this issue in *Burks v. Lasker*. *Id.* at 121 n.12. The court indicated that although the statements in *Burks* may technically be considered dicta, "the Court's observation formed an integral part of its reasons for holding that the directors had broader powers under other parts of the



Similarly, the Third Circuit, in *Weiss v. Temporary Investment Fund, Inc.*,<sup>93</sup> held that actions under section 36(b) must comply with Rule 23.1. The Third Circuit found the legislative history extensive but unclear.<sup>94</sup> Noting that the language of section 36(b) provides expressly for actions by the SEC or a security holder, the court nonetheless concluded that a private right of action existed in the fund itself.<sup>95</sup> The court observed that the general thrust of the statutory scheme is to preserve the role of the independent directors rather than to make the courts the decisionmakers in setting investment adviser fees.<sup>96</sup>

The Third Circuit expanded the analysis for finding an implied cause of action to include consideration of the *Cort v. Ash* test.<sup>97</sup> After a thorough review of the legislative history of section 36(b), the court concluded that an analysis of all four prongs of the *Cort* test indicated that the investment company itself had a cause of action under section 36(b).<sup>98</sup>

### III. The *Daily Income Fund, Inc. v. Fox* Decision

#### A. *The Facts*

Martin Fox was a shareholder in the Daily Income Fund, Inc., an open-end investment company (mutual fund).<sup>99</sup> Reich & Tang, Inc. (R&T) was the fund's investment adviser.<sup>100</sup> R&T was paid an annual fee for its services, one-half of one percent of the fund's net asset balance, irrespective of any fluctuation in

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Act. The statement was by no means gratuitous or obiter." *Id.*

For a discussion of *Burks v. Lasker*, see *supra* notes 75-80 and accompanying text. 93. 692 F.2d 928 (3d Cir. 1982).

94. *Id.* at 930.

95. *Id.* at 934. The court noted its agreement with the First Circuit decision in *Grossman. Id.* For a discussion of *Grossman*, see *supra* notes 88-92 and accompanying text.

96. *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d at 937.

97. *Id.* at 934-35. The Third Circuit recognized that the implication of a corporate right of action from a statute expressly bestowing the right to sue in the shareholder was somewhat atypical; nevertheless, the court considered the test to be a valid measure of the power inherent in the statute. *Id.* at 934 n.8. For a discussion of *Cort v. Ash*, see *supra* notes 63-64 and accompanying text.

98. *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d at 936.

99. *Daily Income Fund, Inc. v. Fox*, 104 S. Ct. 831, 833 (1984). Open-end funds offer securities to the public on a continuing basis and are legally obligated to repurchase those shares at their current net asset value. 15 U.S.C. § 80a-5 (1976).

100. *Fox*, 104 S. Ct. at 833.

the fair market value of those assets.<sup>101</sup>

Because of this flat fee arrangement and the dramatic growth of the mutual fund industry in general, the fees paid to R&T escalated astronomically without a corresponding increase in the services required of it.<sup>102</sup> Fox, as a shareholder in the fund, questioned why the investment adviser should receive such inordinately high fees for services which were substantially identical to those performed prior to the fund's growth.<sup>103</sup>

Fox brought suit in the United States District Court for the Southern District of New York, alleging that the management of the fund's assets was a routine task and that the increased fees were based solely on the growth of the fund's assets and not on increased management costs.<sup>104</sup> Rather than ask the board of directors to demand a return of the excessive fees,<sup>105</sup> Fox alleged in his complaint that no demand was required under ICA section 36(b).<sup>106</sup> R&T responded by moving to dismiss for failure to comply with Rule 23.1.<sup>107</sup>

The district court noted that there was a divergence of opinion on this issue within the Second Circuit.<sup>108</sup> Nevertheless, it concluded that the requirements of Rule 23.1 were applicable to section 36(b) actions and dismissed Fox's complaint.<sup>109</sup> The

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101. *Id.* at 833.

102. *Id.* The net assets of the Daily Income Fund, Inc. experienced a dramatic growth in a relatively short period of time. In 1978, the funds net assets were worth approximately \$75 million. Less than three years later, those assets had reached a value of almost \$775 million. Based on the flat rate of one-half of one percent, the fees paid to Reich & Tang by the fund rose from \$375,000 in 1978 to approximately \$3,875,000 in 1981. *Id.*

103. *Id.*

104. *Id.* (citing *Fox v. Reich & Tang, Inc.*, 692 F.2d 250, 250 (2d Cir. 1982)). Section 36(b) expressly makes any action under the ICA a federal question. 15 U.S.C. § 80a-35(b)(5) (1976).

105. For a discussion of the policy justification behind Rule 23.1, see *supra* notes 84-87 and accompanying text.

106. *Fox v. Reich & Tang, Inc.*, 692 F.2d 250, 253 (2d Cir. 1982).

107. *Fox*, 104 S. Ct. at 834.

108. *Fox v. Reich & Tang, Inc.*, 94 F.R.D. 94 (S.D.N.Y. 1982). There had been disagreement among the district courts in the Second Circuit itself on whether a Rule 23.1 demand was required in a § 36(b) suit. Compare *Markowitz v. Brody*, 90 F.R.D. 542 (S.D.N.Y. 1981) (holding that Rule 23.1 applies to § 36(b) suits) with *Blatt v. Dean Witter*, 582 F. Supp. 1152 (S.D.N.Y. 1982) (holding that § 36(b) actions differ from the traditional derivative action suits and therefore Rule 23.1 does not apply).

109. *Fox v. Reich & Tang, Inc.*, 94 F.R.D. at 98-99.

Second Circuit reversed, holding that the demand requirement of Rule 23.1 was inapplicable to suits brought under section 36(b).<sup>110</sup> The Supreme Court granted certiorari to consider the question of whether an action under section 36(b) of the ICA is exempt from the demand requirement of Rule 23.1.<sup>111</sup>

## B. *The Decision*

### 1. *Opinion of the Court*

Justice Brennan, writing for the Court, held that the demand requirement of Rule 23.1 does not apply to suits brought under section 36(b) of the ICA.<sup>112</sup> He cited three reasons for reaching this conclusion. First, violation of the rights asserted under section 36(b) requires a remedy which can be enforced *only* by the SEC or a security holder of the company.<sup>113</sup> Second, the investment company does not have an implied right of action under section 36(b).<sup>114</sup> Third, the term "derivative action" defines the scope of Rule 23.1 and limits its application to those actions which the investment company itself can bring.<sup>115</sup> Since no express or implied cause of action exists in favor of the fund, the action is not derivative and, therefore, not subject to the demand requirement of Rule 23.1.<sup>116</sup>

Justice Brennan's analysis began with a review of the scope of Rule 23.1. He examined the judicial development and previous interpretations of the Rule,<sup>117</sup> and determined that the Rule is restricted to those actions which can be "brought by one or more shareholders or members to enforce a right of a corporation [when] the corporation has failed to enforce a right which

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110. *Fox v. Reich & Tang, Inc.*, 692 F.2d at 262.

111. *Fox*, 104 S. Ct. at 833.

112. *Id.* at 842.

113. *Id.* at 838.

114. *Id.* at 839-42.

115. *Id.* at 834-38.

116. *Id.* at 842.

117. *Id.* at 834-38. Justice Brennan concluded that the *Hawes* requirements were "designed to limit the use of the device [derivative actions] to situations in which, due to an unjustified failure of the corporation to act for itself, it was appropriate 'to permit a shareholder to institute and conduct a litigation which usually belongs to the corporation.'" *Id.* at 836 (citing *Hawes v. Oakland*, 104 U.S. 450, 460 (1881)).

may properly be asserted by it."<sup>118</sup> Accordingly, the Court had to determine whether the right asserted under section 36(b) could be enforced by the fund in its own right.<sup>119</sup>

In determining whether the fund had a cause of action under section 36(b), the Court looked to the language of the statute. As Justice Brennan noted, the statute provides that "[a]n action may be brought . . . by the [Securities and Exchange] Commission or by a security holder."<sup>120</sup> Justice Brennan concluded that "[b]y its terms, then, the usual cause of action created by § 36(b) differs significantly from those traditionally asserted in shareholder derivative suits."<sup>121</sup> Based on the language of the statute, the Court concluded that the remedy provided by it can be enforced only by the SEC or a security holder, and not by the investment company itself.<sup>122</sup> Since it found no express authorization for the fund to bring an action to recover excessive advisory fees, the Court addressed the position urged by the fund that an implied cause of action exists in favor of the fund under section 36(b).<sup>123</sup> This contention was based on the Court's prior decisions governing implied causes of action.<sup>124</sup> Justice Brennan began with an analysis of congressional intent, focusing on the procedure surrounding the passage of the Act and the discussions concerning the new standard of fiduciary duty established to govern board actions.<sup>125</sup> The Court observed that "Congress rejected a proposal that would have expressly made the statutory standard governing adviser fees enforceable by the investment company itself and adopted in its place a provision containing none of the indications in earlier drafts that the company could bring such a suit."<sup>126</sup> Furthermore, the Court noted that the Senate Report indicated that even though shareholder and director approval of advisers' contracts was to be given serious consideration, "such consideration would not be

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118. *Fox*, 104 S. Ct. at 834-35 (citing Rule 23.1) (emphasis omitted).

119. *Fox*, 104 S. Ct. at 838.

120. *Id.*

121. *Id.*

122. *Id.* at 842.

123. *Id.* at 839.

124. See *supra* notes 60-69 and accompanying text for a discussion of the implication of private rights of action.

125. *Fox*, 104 S. Ct. at 839-41. See *supra* notes 50-58 and accompanying text.

126. *Fox*, 104 S. Ct. at 840-41.

controlling in determining whether or not the fee encompassed a breach of fiduciary duty."<sup>127</sup> Thus, according to the Court, Congress did not intend to create an implied cause of action in favor of the corporate fund.

Justice Brennan concluded by reviewing the *Cort v. Ash*<sup>128</sup> factors.<sup>129</sup> Without any detailed explanation, he found that although the fund was undoubtedly in the class to be benefited by the legislation, the shareholder's express cause of action was sufficient to vindicate the company's right.<sup>130</sup> Furthermore, he considered section 36(b) to have created an entirely new right and, therefore, not to have been enacted in a context where a previous implied private remedy was already recognized by the courts.<sup>131</sup> Finally, Justice Brennan determined that the traditional law governing corporations was to be determined by reference to state, not federal law.<sup>132</sup>

## 2. Concurrence

In his concurring opinion, Justice Stevens asserted that even if the action were to be considered derivative in nature, Rule 23.1 was concerned solely with the adequacy of the pleadings and was not a condition precedent to a shareholder suit.<sup>133</sup>

127. *Id.* at 841 (citing S. REP. NO. 184, 91st Cong., 1st Sess. 15, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4910).

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

129. *Fox*, 104 S. Ct. at 841-42. See *supra* notes 63-64 and accompanying text for a discussion of *Cort v. Ash*.

130. *Fox*, 104 S. Ct. at 841.

131. *Id.* at 841-42. By calling the remedy under § 36(b) a "new right," Justice Brennan was able to ignore the *Merrill Lynch* analysis. *Id.* See *supra* notes 67-69 and accompanying text discussing *Merrill Lynch, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982).

132. *Fox*, 104 S. Ct. at 842. *Id.* at 841. See *supra* note 64 and accompanying text. Without explanation the Court overruled the reasoning of the Third Circuit in *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d 928 (3d Cir. 1982), regarding its *Cort v. Ash* analysis. See *supra* notes 97-98 and accompanying text.

133. *Fox*, 104 S. Ct. at 842 (Stevens, J., concurring). Justice Stevens concluded that the plain wording of the statute made it clear that the Rule did not require demand, but only that the complaint allege whether or not a demand had been made. Justice Stevens reviewed the history of the Rule and concluded that as originally enacted, the Rule did not require a demand to be made; this requirement had been judicially created in *Hawes v. City of Oakland*. *Id.* at 842 (Stevens, J., concurring) (citing *Hawes v. City of Oakland*, 104 U.S. 450 (1881)). See *supra* note 85. Justice Stevens supported this construction with an analysis of the Rules Enabling Act which states that federal "rules shall not

Justice Stevens concluded that the rule would be applicable only if it were considered an implicit intracorporate procedural requirement.<sup>134</sup>

Justice Stevens, in an analysis paralleling the Court's review of the express language of the statute, concluded that had Congress intended to include a demand requirement it would have explicitly stated as much.<sup>135</sup> He also considered the policy justifications for a demand requirement and found that its use in the context of a section 36(b) suit would frustrate the basic purposes for which the Rule was designed.<sup>136</sup>

#### IV. Analysis

The Supreme Court, in reaching its conclusion in *Daily Income Fund, Inc. v. Fox*<sup>137</sup> that the investment fund does not have an implied cause of action under section 36(b), concentrated solely on the legislative history of the 1970 amendments.<sup>138</sup> The Court found the history relatively clear and concise, and concluded that there was no indication that Congress intended to imply a private right of action for the fund.<sup>139</sup>

That the Court found the legislative history clear is somewhat surprising. Several circuit courts, reviewing the same his-

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abridge, enlarge or modify any substantive right." *Fox*, 104 S. Ct. at 843 n.2 (Stevens, J., concurring) (citing 28 U.S.C. § 2072 (1976)).

134. *Fox*, 104 S. Ct. at 843 (Stevens, J., concurring). Justice Stevens framed the issue for resolution as "whether [a] federal statute that expressly creates a cause of action that the shareholder may maintain on behalf of the mutual fund implicitly conditions that express right on an unmentioned intracorporate procedural requirement." *Id.* at 843 (Stevens, J., concurring).

135. *Id.* at 843 (Stevens, J., concurring).

136. *Id.* at 844 (Stevens, J., concurring). Justice Stevens specifically noted the fact that the fund directors were involved in the approval of the adviser contracts. *Id.* (Stevens, J., concurring) (citing 15 U.S.C. § 80a-15 (1976)). See *supra* text accompanying note 29. Justice Stevens also accepted the *Burks* holding that the fund directors could not terminate shareholder suits. *Fox*, 104 S. Ct. at 844 (Stevens, J., concurring) (citing *Burks v. Lasker*, 441 U.S. 471, 484 (1979)). He was concerned with the statutory provision limiting recovery of fees paid one year prior to the commencement of the suit. He believed that this, coupled with the inability of the directors to terminate a suit, would simply allow the directors to collect more excess fees and therefore, frustrate the policy behind the statute. *Fox*, 104 S. Ct. at 844 (Stevens, J., concurring) (citing 15 U.S.C. § 80a-35(b)(3) (1976)).

137. 104 S. Ct. 831 (1984).

138. *Fox*, 104 S. Ct. at 840-41.

139. *Id.* at 839-41.

tory found it unclear as to whether Congress intended to create an implied remedy.<sup>140</sup> Moreover, the Court's unexplained emphasis on the legislative debates to the exclusion of pre-amendment developments caused it to overlook the importance of a statement in the Senate Report: "[T]hat subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)."<sup>141</sup> This statement seems to indicate that any rights previously existing under section 36 continue to exist under section 36(a).

Since there was no clear congressional mandate restricting any rights existing under section 36, it was incumbent upon the Court to examine that section as it existed prior to the amendment.<sup>142</sup> As the Court stated in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*,<sup>143</sup> "[w]hen Congress acts in a statutory context in which an implied private remedy has *already* been recognized . . . , the question is whether Congress intended to preserve the pre-existing remedy."<sup>144</sup> Had the Court followed the analysis it prescribed in *Merrill Lynch*, perhaps it would have reached a different result in *Fox*.

The *Merrill Lynch* analysis would have revealed the importance of the Senate Report statement, regarding the effect of the addition of subsection (b), in light of the Second Circuit's decision in *Brown v. Bullock*.<sup>145</sup> The *Brown* court determined that an implied derivative cause of action existed in the mutual fund under section 36.<sup>146</sup> It expressly dismissed the argument that Congress implicitly precluded the fund's remedy by specifically

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140. See, e.g., *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d 928, 935 (3d Cir. 1982) (noting that contradictory conclusions could be drawn from the legislative history); *Fox v. Reich & Tang, Inc.*, 692 F.2d 250, 258 (2d Cir. 1982) (stating that the extensive legislative history neither approves nor disapproves suits by the fund itself); *Grossman v. Johnson*, 674 F.2d 115, 121-22 (1st Cir. 1982) (describing the conflicting legislative indications regarding the roles of the directors).

141. S. REP. No. 184, 91st Cong., 2d Sess. 16, *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4897, 4911.

142. Section 36 of the ICA was substantially incorporated into the 1970 amendments as § 36(a). See *supra* notes 47-51 and accompanying text.

143. 456 U.S. 353, 378-79 (1982).

144. *Id.* at 378-79. See *supra* notes 66-69 and accompanying text.

145. 194 F. Supp. 207 (S.D.N.Y.), *aff'd on other grounds*, 294 F.2d 415 (2d Cir. 1961). See *supra* notes 70-74 and accompanying text.

146. *Brown v. Bullock*, 194 F. Supp. at 245.

authorizing the SEC action.<sup>147</sup> In addition, the Supreme Court in *Burks v. Lasker*<sup>148</sup> had implicitly accepted the *Brown* rationale. In *Burks*, the Supreme Court noted that the fund shareholders have "implied, derivative causes of action under the ICA."<sup>149</sup> Thus, it is arguable that the analysis prescribed by *Merrill Lynch* would reveal that the fund still possessed an implied cause of action in its favor under section 36(b).

With *Brown* and *Burks* as a basis for recognizing a section 36 derivative action, *Merrill Lynch* would then require that a court extend its review of the amendment in light of the previously recognized right. Had the *Fox* Court followed this analysis, it would have had to determine whether the rights which apparently were judicially recognized under the pre-amendment section 36, had been expressly diminished or curtailed by the amendment.

A more thorough review of the legislative history would have revealed that the intent behind section 36(b) was to enhance the pre-existing remedy under section 36.<sup>150</sup> The Senate Report accompanying the ICA stated that subsection (b) was enacted to "specify that the adviser has a fiduciary duty with respect to compensation, and provide a mechanism for court enforcement of [that] duty."<sup>151</sup> The history is replete with references to the congressional goal of "strengthen[ing] the ability of the unaffiliated directors to deal with" the problem of management fees.<sup>152</sup> Furthermore, the Chairman of the SEC cited to the remedy created under *Brown* in his testimony. In response to questioning, the Chairman stated: "[T]he commission has consistently supported the recognition of private rights of action . . . . The courts have generally accepted our [the SEC] position."<sup>153</sup> This direct reference to the Second Circuit's

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147. *Id.*

148. 441 U.S. 471 (1979). See *supra* notes 75-80 and accompanying text.

149. *Burks v. Lasker*, 441 U.S. at 476.

150. *Id.* at 484-85.

151. S. REP. No. 184, 91st Cong., 1st Sess. 6, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4902.

152. S. REP. No. 184, 91st Cong., 1st Sess. 7, reprinted in 1970 U.S. CODE CONG. & AD. NEWS 4897, 4903. Cf. *Burks v. Lasker*, 441 U.S. at 485 (Justice Brennan had previously recognized that one congressional goal on enacting the ICA was to strengthen the role of the independent directors). See *supra* note 77.

153. *Investment Company Act Amendments of 1967: Hearings on H.R. 11995, S.*



opinion regarding the existence of the private right of action should have been an indication to the *Fox* Court that the amendments did not eliminate the fund's remedy under section 36. In addition, the Chairman further stated that section 36(b) did not "leave the door open to [a] nuisance action, [since there exist] adequate safeguards under the *Federal Rules of Civil Procedure* and this bill to prevent unjustified shareholder litigation."<sup>154</sup> These statements by the Chairman suggest that Congress enacted the amendments on the assumption that the protections provided by Rule 23.1 remained intact, although admittedly the reference is ambiguous.

From these indications of legislative intent, it is arguable that the Court's analysis concentrated too much on the procedural aspects of the bill's passage and too little on the conflicting statements underlying those actions. Although the absence of clear congressional indication regarding the pre-existing rights under section 36 does not automatically render section 36(b) actions derivative, the Court may have passed over, too quickly, the legislative indications that Congress sought to strengthen the director's role in determining fee arrangements.

### V. Impact of the Decision

Striking down the demand requirement of Rule 23.1, as applied to suits brought under section 36(b), raises two problems related to the purposes of the Rule. One purpose served by the Rule is to allow the directors to assume their proper role as managers of the fund.<sup>155</sup> Although it has been noted that the directors upon whom the demand is served usually are the very same directors that originally negotiated the fees,<sup>156</sup> allowing the directors to review the fees at the behest of the shareholders permits them to fulfill their corporate role and coincides with the purposes of the ICA. References in the legislative history to

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2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Fin. of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 1st Sess. 201 (1967) [hereinafter cited as *Hearing*] (statement of SEC Chairman Hamer Budge) (citing to *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961)).

154. *Hearing*, *supra* note 153. (statement of SEC Chairman Hamer Budge) (emphasis added).

155. *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d 928, 940 (3d Cir. 1982).

156. See *supra* notes 11-17 and accompanying text.

Congress' effort to strengthen the role of the independent directors,<sup>157</sup> and the fact that the courts have recognized that they should not presume the self-interest of the directors,<sup>158</sup> lead to the conclusion that the directors should be left to perform their managerial function subject to ultimate judicial review for management's failure to fulfill its statutorily created fiduciary duty.

A second purpose of Rule 23.1 is to allow the board to review and prevent expensive and frivolous litigation.<sup>159</sup> Eliminating the demand requirement creates the possibility that the already overcrowded court dockets will become even more crowded with unwarranted litigation. Even with the internal controls of the ICA,<sup>160</sup> the opportunity to challenge what may be viewed as excessive fees for unknown services may lead to unnecessary access to the federal courts. One court has even noted that the provisions of Rule 23.1 may be necessary to preclude creating a market in vexatious advisory fee suits.<sup>161</sup>

The Court appears to have taken a needless step to provide adequate relief to the shareholders. Even with the requirements of Rule 23.1, the shareholder is not barred from seeking judicial review.<sup>162</sup> The Rule simply requires that the board be given the initial opportunity to consider the complaint. The shareholders are not deprived of a remedy in the event an unyielding board refuses to consider the demand. Rule 23.1 provides a forum in federal court once the plaintiff has submitted a properly pleaded complaint and the board has not responded to the shareholders' demand.<sup>163</sup> It would appear that the relaxation of the demand requirement impinges on a legitimate management function and

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157. See *supra* notes 27-29 & 55 and accompanying text.

158. *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d at 940.

159. *Markowitz v. Brody*, 90 F.R.D. 542, 561 (S.D.N.Y. 1981).

160. See 15 U.S.C. §§ 80a-15(a), -35(b)(3) (1976) (all contracts with the investment adviser must be approved by the shareholders, and the remedy for suits brought under § 36(b) is limited to actual damages sustained within one year from the commencement of the suit).

161. *Markowitz v. Brody*, 90 F.R.D. at 554 n.10 (concerning the contemporaneous ownership requirement of Rule 23.1).

162. Rule 23.1 plainly states: "[T]he complaint . . . shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and the reasons for his failure to obtain the action or for not making the effort." FED. R. CIV. P. 23.1.

163. *Daily Income Fund, Inc. v. Fox*, 104 S. Ct. 831, 842 (1984) (Stevens, J., concurring).

will create an excessive burden on the courts.

## VI. Conclusion

In *Daily Income Fund, Inc. v. Fox*,<sup>164</sup> the Supreme Court held that a shareholder need not make a demand on the directors of a mutual fund pursuant to Rule 23.1 when challenging the mutual fund adviser's fee under section 36(b) of the ICA. The Court reasoned that a suit under section 36(b) is not derivative, since there is neither an express nor implied cause of action in favor of the fund. Because the action is not derivative, shareholders should not be required to present their complaints to the fund before seeking judicial review of the reasonableness of the adviser's fee.

The Court's conclusion permits shareholders to circumvent the procedural safeguards normally afforded by Rule 23.1 for suits brought on behalf of a corporation. The shareholder is now free to pursue his challenge in federal court without first presenting it to the board. This result represents an unnecessary interference with the managerial function performed by the board and a further burden on already overburdened dockets. Requiring that a shareholder comply with Rule 23.1 would assure adequate respect for the business judgment of the fund's board, without jeopardizing the shareholder's interest in obtaining judicial review of advisory fees. It is unfortunate that the Court disturbed this balance created by the Rule 23.1 demand requirement.

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164. 104 S. Ct. 831 (1984).