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Securities Regulation -- Investment Company Act of 1940 -- Control Transfer Profits -- Fiduciary Duty of Mutual Fund Advisers -- Kukman v. Baum

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bringing early challenges to specious patents: *Blonder*, in permitting summary judgment of an infringement suit instituted subsequent to a third party adjudication of invalidity, would permit competitors of the licensee to engage in open violation of a weak patent with little economic risk, thereby compelling the licensee to challenge the patent as early as possible, regardless of whether or not recoupment would accompany a successful challenge. It is submitted that further development of a point made in the opinion would add support to the court's conclusion: that recoupment might erode the very foundations of the federal patent system by compelling inventors to forego patents and seek instead the protection of the trade secret agreement, thereby upsetting the present delicate balance between patent and trade secret law. Finally, principles of state contract law and antitrust law provide additional grounds, though not utilized by the Sixth Circuit, for refusing recoupment. Specifically, Troxel should be barred from seeking restitution of royalty payments under state contract law because he had received considerable benefit from use of the patent; and if recoupment were made available as the district court proposed, licensing agreements could be deemed to incorporate the remedy by implication and accordingly would be characterized as unreasonable restraints of trade.

HOWARD B. BARNABY, JR.

Securities Regulation—Investment Company Act of 1940—Control Transfer Profits—Fiduciary Duty of Mutual Fund Advisers—*Kukman v. Baum*¹—Securities Supervisors, Inc. (Supervisors) served as the investment adviser and principal underwriter² for three open-end investment companies³—Selected American Shares, Inc. (Selected American), Selected Special Shares, Inc. (Selected Special), and Selected Opportunity Fund, Inc. (Selected Opportunity)—pursuant to management agreements between each of the funds and Supervisors.⁴

¹ 346 F. Supp. 55 (N.D. Ill. 1972).

² As investment adviser, Supervisors provided, in addition to other incidental services, supervision of investment and analysis of companies, securities, and economic conditions, and also furnished statistical, administrative and bookkeeping services, as well as office space and personnel. *Id.* at 56 n.1.

"As principal underwriter, Supervisors acts as agent of the funds in selling their shares, at a discount from the public offering price, to dealers who in turn sell the shares to the public at the applicable public offering price." *Id.* at 56.

³ The funds are investment companies registered pursuant to the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (1970) [hereinafter referred to as the Act]. Section 80a-5(a)(1) defines an open-end company as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer." For a collection of authorities discussing the history of the Act see Comment, *Protecting the Interests of Mutual-Fund Investors in Sales of Management-Corporation Control (or, Policing the Traffic in Other People's Money)*, 68 Yale L.J. 113 n.4 (1958).

⁴ Section 15(a) provides: "It shall be unlawful for any person to serve or act as

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In 1969, defendant majority shareholders of Supervisors conducted negotiations for the sale of approximately eighty percent of Supervisors' stock to defendant International Industries, Inc. (International).⁵ Under the Investment Company Act of 1940, such a sale would be characterized as an assignment⁶ and accordingly would terminate the management and underwriting agreements between Supervisors and the funds and necessitate the fund shareholders' approval of new management and underwriting agreements between Supervisors and each of the funds.⁷ Hence completion of the transaction was conditioned upon approval of the new contracts by the shareholders of each of the funds.⁸

The directors of each of the funds approved the proposed agreements and adopted resolutions recommending to the funds' shareholders the continuation of Supervisors as investment adviser and principal underwriter under the new management and underwriting agreements.⁹ Then, in August 1969, the funds' shareholders approved the new agreements. The sale of eighty percent of the stock of Supervisors to International was completed shortly thereafter.¹⁰

investment adviser of a registered investment company, except pursuant to a written contract, which contract . . . has been approved by the vote of a majority of the outstanding voting securities of such registered company . . ." 15 U.S.C. § 80a-15(a) (1970).

⁵ Slightly less than 80% of the stock of Supervisors was owned by a group of four men who composed the senior management team of Supervisors. The remaining 20% stock interest was retained by eight younger executives. 346 F. Supp. at 57.

⁶ Assignment is defined as "any direct or indirect transfer or hypothecation of a contract . . . or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor . . ." 15 U.S.C. § 80a-2(a)(4) (1970).

⁷ 15 U.S.C. §§ 80a-15(a)(4), (b)(2) (1970).

⁸ 346 F. Supp. at 58.

⁹ Section 15(c) of the Act provides that:

[I]t shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser or principal underwriter for such company, unless the terms of such contract . . . have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.

15 U.S.C. § 80a-15(c) (1970).

Section 10(a) provides that "No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company." In 1969, the board of directors of Selected American and Selected Special were identical and consisted of seven directors, only one of whom was "interested" in Supervisors. 346 F. Supp. at 58. For the duties of independent directors see Comment, Duties of the Independent Director in Open End Mutual Funds, 70 Mich. L. Rev. 696, 724-27 (1972); Nutt, A Study of Mutual Fund Independent Directors, 120 U. Pa. L. Rev. 179, 202-05, 242-46 (1971).

¹⁰ At special meetings held on August 20, 1969, the shareholders of Selected American

In late 1970, International experienced a liquidity problem and sought to sell its shares in Supervisors.¹¹ Lincoln National Corporation (Lincoln) proposed to buy all of the outstanding stock of Supervisors.¹² As in the first sale, the transaction was conditioned upon approval of new management agreements by the funds' shareholders.¹³ The directors of the three funds approved the continuation of Supervisors¹⁴ as adviser and underwriter under the new agreements, and those agreements were approved by shareholders of the three funds at shareholders' meetings in May, 1971. Thereafter the sale to Lincoln of all the stock of Supervisors was completed.

Plaintiff, a shareholder of one of the funds, sued both the original majority shareholders of Supervisors who had sold to International, and International, asserting that the former had received an excess of approximately ten million dollars over the net asset value of Supervisors stock, and that the latter, in the subsequent sale to Lincoln, had received an excess over net asset value of approximately \$5,787,000. Plaintiff contended that the two sales constituted assignments at a profit of a fiduciary office—that of investment adviser to and underwriter for the funds—in violation of common law fiduciary principles. Plaintiff further asserted that all such profit belonged to the funds as a matter of law.¹⁵ On cross motions for summary judgment, the United States District Court for the Northern District of Illinois HELD: An investment advisory company's shareholders who sell their controlling interest in the advisory company may retain the profits without breaching their fiduciary duty under the Investment Company Act of 1940, since the Act does not impliedly incorporate common law fiduciary principles.

In granting summary judgment to the defendants, the *Kukman* court tacitly followed the result of the Ninth Circuit in *SEC v. Insurance Securities, Inc.*,¹⁶ which held that an investment company's controlling shareholders who sold their interest in the advisory company may retain their profits without violating the Investment Company Act. *Kukman*, however, explicitly held what *Insurance Securities* had only suggested: that common law fiduciary principles¹⁷ were

and Selected Special approved the new agreements, and on September 10 the sale of 80% of the stock of Supervisors to International was closed. 346 F. Supp. at 58. Stockholder approval by Selected Opportunity was not necessary because its stock was not offered to the public until August, 1970. *Id.* at 58 n.7.

¹¹ *Id.* at 59.

¹² *Id.* at 59. As part of the purchase, Lincoln planned to buy the remaining 20% which was held by a group of younger executives of Supervisors. *Id.*

¹³ *Id.* at 59.

¹⁴ The investment adviser was to retain the name "Supervisors."

¹⁵ 346 F. Supp. at 60.

¹⁶ 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958).

¹⁷ The common law fiduciary principles involved are as follows: A fiduciary may not sell his influence with respect to his fiduciary obligee. *West v. Camden*, 135 U.S. 507, 520 (1890); *Kratzer v. Day*, 12 F.2d 724, 726 (9th Cir. 1926); *Reed v. Catlett*, 288 Mo. App. 109, 68 S.W.2d 734 (1934). A fiduciary may not take advantage of opportunities which

not impliedly incorporated into the Investment Company Act. The rulings in *Kukman* and *Insurance Securities* are in direct contrast to the Second Circuit's controversial holding in *Rosenfeld v. Black*¹⁸ that the Investment Company Act impliedly incorporates the common law prohibition against the sale of a fiduciary office for a profit and thereby forbids personal gain by a mutual fund investment adviser on the transfer of its advisory contract.

Several factors, which will be referred to below in some detail, render the *Kukman* court's interpretation of the Investment Company Act significant: the conflicting views of the courts as manifested in *Kukman*, *Insurance Securities*, and *Rosenfeld*, and the uncertainty such differing interpretations must occasion within the large mutual funds industry; the number of pending suits brought on the basis of *Rosenfeld*; and the proposed federal legislation concerning control transfer profits.

This note will examine *Kukman* in light of prior case law and the legislative history of the 1970 amendments to the Investment Company Act. It will be submitted that, although the *Kukman* court correctly rejected both the result and the rationale of *Rosenfeld*, it did not go as far as it might have in providing a justification for its holding. Finally, the note will examine briefly current proposed federal legislation intended to resolve the problems involved in control transfer situations.

The first case decided under the Investment Company Act which confronted the question of whether the controlling shareholders of an investment adviser could retain the profits from the sale of their interest therein was *SEC v. Insurance Securities, Inc.*,¹⁹ a case decided prior to the passage of the 1970 amendments. On facts similar to those from which the *Kukman* litigation arose, the SEC brought an action for injunctive relief and for an accounting, claiming that the actions of the defendant directors of an investment adviser, who had sold a controlling interest therein to a group of purchasers at a price greatly in excess of the net asset value of the stock, constituted "gross abuse of trust" and "gross misconduct" which were expressly pro-

he may pursue only on behalf of his fiduciary obligee. *Young v. Higbee Co.*, 324 U.S. 204, 212-13 (1945); *Pepper v. Litton*, 308 U.S. 295, 311 (1939); *Clarke v. Greenberg*, 296 N.Y. 146, 71 N.E.2d 443 (1947). The dominant shareholders of a corporation may not sell a controlling interest in the corporation to outsiders, where the result would be to deprive the corporation of opportunities for gain from controlling distribution to such outsiders. *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955). A personal trustee, corporate officer or director may not sell or transfer such office for personal gain. *Gaskell v. Chambers*, 26 Beav. 360, 53 Eng. Rep. 937 (1858); *McClure v. Law*, 161 N.Y. 78, 55 N.E. 388 (1899); *Porter v. Healy*, 244 Pa. 427, 91 A. 428 (1914). Directors of a solvent corporation may not take over for their own profit an opportunity available to the corporation. *Irving Trust Co. v. Deutsch*, 73 F.2d 121 (2d Cir. 1934). The assets of a corporation may not be wasted or looted by corporate officers acting in a fiduciary capacity. *Bosworth v. Allen*, 168 N.Y. 157, 61 N.E. 163 (1901).

¹⁸ 445 F.2d 1337 (2d Cir. 1971), settled, 336 F. Supp. 84 (S.D.N.Y. 1972).

¹⁹ 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958).

hibited by section 36 of the Act.²⁰ The specific misconduct alleged was the sale of control in excess of net asset value: the complaint alleged that the receipts from the sale represented payment for succession to the adviser's fiduciary office in violation of common law fiduciary principles. The SEC also argued that the value attached to the advisory contracts was an asset of the fund which, under common law fiduciary principles, could not be appropriated by the investment adviser.²¹ For these reasons, the SEC contended that the sale of a controlling interest in an adviser at a price in excess of net asset value was contrary to general equitable principles. These principles, the SEC urged, were incorporated into section 36.²²

The United States Court of Appeals for the Ninth Circuit affirmed the district court's dismissal of the complaint, reasoning that the fiduciary principles referred to in the complaint were not applicable to control transfer cases. The court concluded that the Act provided for specific shareholder remedies aimed at prevention of transfers of control contrary to the interests of the fund and that these remedies were intended to be exclusive.²³ The appellate court in *Insurance Securities* began its analysis of the Act by examining the policy position contained in the preamble and the remedies provided for in the other sections of the Act. Section 1(b)(6) declares that a transfer of control without investor consent is contrary to public policy.²⁴ The court ruled that Congress provided a remedy for that evil in section 15(a)(4) of the Act, which provides for automatic termination of the advisory contract in the event of an assignment.²⁵ The *Insurance Securities* court, in reading the two sections together, concluded:

[T]he sanction runs against any assignment, whatever the price paid and received therefor. An assignment at net asset value is just as fruitless under the section as one for a substantial price in excess of such value. In either case, the contract is automatically terminated. In no respect is the amount

²⁰ Section 36 as then written provided:

The Commissioner is authorized to bring an action . . . alleging that a person serving . . . in one or more of the following capacities has been guilty . . . of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts: (1) as officer . . . of an investment advisor, . . . or (2) is principal underwriter
Investment Company Act of 1940, ch. 686, tit. I, § 36, 54 Stat. 841 (1940).

²¹ 254 F.2d at 647-48.

²² *Id.* at 648.

²³ 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958).

²⁴ Section 1(b) provides that ". . . it is declared that the national public interest and the interest of investors are adversely affected . . . (6) when investment companies are reorganized . . . or when the control or management thereof is transferred without the consent of their security holders." 15 U.S.C. § 80a-1(b) (1970).

²⁵ Section 15(a) provides: "It shall be unlawful for any person to serve or act as investment advisor . . . except pursuant to a written contract . . ." Section 15(a) provides in substance for its automatic termination in the event of its assignment. 15 U.S.C. § 80a-15(a) (1970).

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paid or received for stock control made a factor to be considered.²⁶

The court then dealt with the two fiduciary principles set forth in the SEC's complaint. First, it found that a fiduciary relationship had existed between the principal shareholders of the investment adviser and the fund by virtue of the service contracts. However, it held that there was no sale of a fiduciary office, since the shift in control automatically terminated the service contracts and ended the fiduciary relationship. The price received for the sale of the stock, then, could not be said to represent compensation for the sale of a fiduciary office.

The court then addressed itself to the SEC's position that there was a violation of the equitable principle that a person occupying a fiduciary relationship will not be permitted to exploit such a relationship for his personal gain in a manner which deprives the beneficiary of assets to which he is entitled.²⁷ The SEC argued that the value attached to the service contract was an asset of the fund. The court found this principle of equity inapplicable, reasoning that the value of the contract did not represent an asset to which the fund was entitled: "The value which the contract has for Trust Fund lies in the fact that Trust Fund receives investment, administrative, and sales services thereunder. That is all that it paid for, and appellant does not contend that Trust Fund received less."²⁸

In examining the remedy provided by section 15(a)(4), the court reasoned that the fund shareholders could deny or approve reinstatement of the advisory contracts. It observed that the automatic termination provision and the ability of the fund shareholders to approve or disapprove the new advisory contract was the specific remedy under the Act and provided a sufficient means of furthering the stated public policy of discouraging transfers of control without investor consent. Therefore, the section 36 prohibition of "gross abuse of trust" was held inapplicable to the facts of *Insurance Securities*.

The *Insurance Securities* case has been criticized on two grounds. The first of these criticisms is based on the *Insurance Securities* court's interpretation of the policy of the Act. It is argued that in relying solely on section 1(b)(6) in elucidating the relevant public policy of the Act, the court improperly ignored section 1(b)(2), which declares that the interests of the public and of investors are adversely affected when investment companies are organized, operated, or managed in the interest of the investment advisers rather than in the interest of the investment companies' security holders. The policy expressed in this provision might be violated if an outgoing investment adviser were allowed to retain the profits from the sale of its advisory contract. As *Rosenfeld v. Black* was later to note, the prime vice of allowing

²⁶ 254 F.2d at 649.

²⁷ See the summary of common law fiduciary principles set out in note 17 supra.

²⁸ 254 F.2d at 650.

the outgoing investment adviser to realize profits in excess of net asset value is that the outgoing adviser can exert his influence on the fund's directors to secure fund shareholder approval of the new contracts. This new contract might not be in the best interests of the mutual fund and its shareholders.²⁹ For example, the desire for large profits might persuade the seller to choose the highest bidder rather than the most competent adviser.³⁰ In addition, if the buyer does pay a high or speculative price for the adviser, it might be tempted to adopt management practices detrimental to the shareholders in order to recoup the high sales price.³¹

The *Insurance Securities* court concluded that because an assignment works a termination of the contract and the fund shareholders are free to reject or approve the new contract, the shareholders are adequately protected by the remedies expressly provided for in the Act. This conclusion may be criticized on the ground that it overlooks the relationship between the "interested" directors of the mutual fund and the outgoing investment adviser.³² Usually a number of the directors of the fund are also officers of the investment adviser. Thus, it is argued, these directors may face a conflict of interest when presented with a potential sale of the investment adviser. As officers of the adviser they will have an interest in maximizing the profit of the potential sale; as directors of the fund they will have a duty to seek a new adviser who will serve in the best interests of the fund and its investors.³³

In 1970, Congress responded to this criticism of *Insurance Securities* by amending section 15(c) of the Act to require approval of the new advisory contract by a majority of the directors of the fund who are not "interested" persons in the outgoing adviser.³⁴ This amendment, however, does not diminish the fact that the "uninterested" directors will still be extremely susceptible to the influence which "interested" persons may exert upon them. Furthermore, even if the directors of the fund act solely in the interest of the shareholders, they may have little choice but to approve the new contract. Failure to approve might leave the "uninterested" directors in the position of having to find and bargain with a new adviser or "would have the disastrous [*sic*] consequences of leaving the company without management."³⁵

The second criticism which has been leveled at the *Insurance Securities* case is directed toward the construction given the Act by the court that section 15(a)(4) provides an adequate and exclusive remedy for shareholders, and hence that section 36 does not express an intent

²⁹ 445 F.2d at 1346 n.13.

³⁰ Comment, 63 Colum. L. Rev. 153, 159 (1963).

³¹ *Id.*

³² See note 9 *supra*.

³³ Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 Geo. Wash. L. Rev. 266 (1959).

³⁴ Investment Company Act of 1940, § 15(c), 15 U.S.C. § 80a-15(c) (1970).

³⁵ House Comm. on Interstate and Foreign Commerce, *Investment Company Amendments Act of 1970*, H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 86-87 (1970).

to incorporate other remedies for control transfer situations. Replying to the court's argument that section 15(a)(4) manifests Congress' intent to provide no remedy against profiteering, one commentator has noted that:

§15(a)(4) is directed at transfers of control without shareholder consent, as distinct from profiteering on a transfer of fiduciary office. Hence, the section on its face hardly compels the conclusion that it is the exclusive antidote for such conduct. The omission of a specific profiteering provision from the Act probably reflects a Congressional belief that section 15(a)(4) would provide an effective prophylaxis against all sales of fiduciary positions and, a fortiori against profiteering from such sales.⁸⁶

In *Rosenfeld* the Second Circuit agreed with this analysis, reasoning that the purpose of section 15 was not to diminish the safeguards already afforded by equity but to provide the additional protection of approval of a new adviser by a majority of the fund shareholders.⁸⁷ One authority had argued: "Even a statute as elaborately drawn as the Investment Company Act could hardly be expected to enumerate and proscribe all possible types of misconduct, fraud or overreaching by which a faithless manager might exploit his position."⁸⁸ These arguments have some appeal and could have been addressed by the *Kukman* court. It will be submitted, however, that although these criticisms were arguably valid ones prior to the 1970 amendments to the Act, they are no longer sustainable in light of the amendments and their legislative history.⁸⁹

Several years after the *Insurance Securities* case, a minority shareholder of a mutual fund brought a derivative suit in the state courts of Delaware seeking restitution of profits realized by the sale of the controlling stock of a management company. In *Krieger v. Anderson*,⁴⁰ the plaintiff claimed on behalf of the Texas Fund the difference between the book value of the shares and the purchase price, but he based his action on common law equitable principles rather than on the Investment Company Act. The plaintiff also alleged that this difference was a premium paid to defendant sellers for their obtaining, through their domination of the Texas Fund board, shareholder approval and reinstatement of the advisory contract. The Supreme Court of Delaware held that independent directors who had worked for shareholder approval of reinstatement of the management contract following a sale of a controlling interest in the management company had not breached their fiduciary duties.

⁸⁶ Comment, *supra* note 3, at 131-33.

⁸⁷ 445 F.2d at 1344-45.

⁸⁸ Greenc, *supra* note 33, at 269-70.

⁸⁹ See the discussion of the legislative history of the 1970 amendments in text at notes 43-49 *infra*.

⁴⁰ 40 Del. Ch. 363, 182 A.2d 907 (1962).

The *Kukman* court approved of the *Krieger* court's reasoning in which it partially justified its decision on policy grounds:

[T]he approval of plaintiff's contention would lead to an anomalous result. Owners of stock of a management company who have built up the value of their shares through the years by the exercise of business ability and good judgment are forbidden ever to reap the reward of their labor. In other words, they can never sell the shares for what they are really worth. This conclusion offends one's sense of fairness. If overriding considerations of public policy requires [*sic*] a curb on the rights of owners of management contracts to realize the full value of their assets, it is for Congress to say so.⁴¹

It is posited that this policy statement represents the underlying rationale of the *Kukman* decision and is illustrative of the prevalent attitude of the mutual fund industry.⁴²

In 1967 Congress undertook a revision of the Act. The SEC in its Mutual Fund Report,⁴³ issued prior to enactment of the amendments, seemed to retreat from the position it took in the *Insurance Securities* case. The Mutual Fund Report noted *inter alia* that common law fiduciary principles might be unfair if they denied all compensation to the management of a fund and recommended that Congress amend the Act to prohibit sales of a controlling block when it appeared affirmatively that such sales were likely to impose additional burdens on the mutual fund or to limit its freedom of future action.⁴⁴

Congress did not accept this recommendation but instead removed the "gross misconduct or gross abuse of trust" standard and authorized the Commission to bring an action under amended section 36(a) against an investment adviser if he had engaged or was about to engage "in any act or practice constituting a breach of fiduciary duty involving personal misconduct . . ."⁴⁵

It is clear from the legislative history of the amendments that

⁴¹ 346 F. Supp. at 65, quoting *Krieger v. Anderson*, 40 Del. Ch. at 367-68, 182 A.2d at 910.

⁴² See, e.g., note 64 *infra*.

⁴³ Securities and Exchange Commission, Report of the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 152 (1966) [hereinafter Mutual Fund Report].

⁴⁴ The Mutual Fund Report, *supra* note 43, at 151-52, noted *inter alia* that: application of the strict common law principle might well be unfair insofar as it denies to the retiring management any compensation for the elements of value in the relationship which they may have built up over the years. The absence of an opportunity to capitalize to the same reasonable degree on the future earnings obtainable from this relationship could also be harmful to the fund, since existing management might be reluctant to surrender that relationship and to provide the fund with new and possibly more effective management.

The Mutual Fund Report also added that "certain of the protective provisions of the Act have had the somewhat ironical and presumably unintended effect of diluting the protections provided by common law principles of fiduciary responsibility." *Id.*

⁴⁵ 15 U.S.C. § 80a-35(a) (1970).

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section 36(a) is not intended as a ground on which the Commission may prosecute investment advisers receiving control transfer profits. The House report stated that section 36(a) "is intended to deal only with . . . violations committed by individuals. It is not intended to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry."⁴⁶ In discussing section 36, the Senate report stated: "A breach of fiduciary duty involving personal misconduct in connection with the transfer of a management organization would be actionable under Section 36 in the same manner as other violations of the statute. Your committee sees no need to single out transfer situations for special treatment."⁴⁷

Congress also added new section 36(b) which provides:

For the purposes of this subsection, the investment adviser . . . 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 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 company⁴⁸

Section 36(b) provides for express fiduciary duties with respect to compensation paid to the adviser by the investment company but makes no reference to control transfer profits. This raises the question: if general fiduciary duties were already incorporated in the Act, as *Rosenfeld* contends, why was it necessary to provide for express fiduciary standards with respect to compensation paid by the investment company? To impliedly incorporate fiduciary duties into the Act would render the express fiduciary duties in section 36(b) mere surplusage. A more probable reading of the Act is that the expressed fiduciary duties contained in section 36(b), and the language of section 36(a) which authorizes the Commission to bring an action for breach of fiduciary duty involving personal misconduct, are the only fiduciary duties expressed or implied in the Act.

The *Kukman* court reviewed this legislative history of the amendment and noted that when Congress amended the Act, it must have been aware of both the *Insurance Securities* and *Krieger* cases, since they were discussed in the Mutual Fund Report. The amendments did not alter the results of those cases. Therefore, the court concluded, the failure of Congress to amend the statute under such circumstances is persuasive evidence of adoption by Congress of the *Insurance Securities* court's construction of section 36.⁴⁹ It is submitted that the *Kukman* court's reasoning presents a sound argument based on the amendments' legislative history. Even if it is considered that *Insurance*

⁴⁶ H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 37 (1970).

⁴⁷ S. Rep. No. 1351, 90th Cong., 2d Sess. 12 (1968).

⁴⁸ 15 U.S.C. § 80a-35(b) (1970).

⁴⁹ 346 F. Supp. at 64.

Securities' suggestion that the fiduciary principles are not incorporated into section 36 of the Act is dictum,⁵⁰ the ultimate result of the case—that an outgoing adviser could keep all of the profits from the sale—was squarely presented to Congress by the Mutual Fund Report, as discussed above. When Congress failed to change the result of the *Insurance Securities* case it must be assumed that it approved of that judicial interpretation of the Investment Company Act.

It is submitted that these statements in the Senate and House reports, viewed in light of the fact that Congress refused to take any legislative action changing the *Insurance Securities* decision, and that it created express fiduciary duties in the amended statute, adequately support the conclusion drawn by *Kukman* that the common law fiduciary principles are not impliedly incorporated into the Act.

*Rosenfeld v. Black*⁵¹ was the first case decided after the 1970 amendments, and it reached a conclusion directly opposite to that of *Insurance Securities*. Plaintiffs, shareholders in the Lazard Fund, Inc., sought *inter alia* an accounting of profits realized by Lazard Freres & Co. (Lazard), an investment banking partnership which had served as the organizer and investment adviser, when Lazard was replaced by Moody's Advisors & Distributors, Inc. (Moody's A&D). Moody's A&D was a wholly owned subsidiary of Moody's Investors Services, Inc. (Moody's Investors), which in turn was a wholly owned subsidiary of Dun & Bradstreet, Inc. (D&B).⁵²

Because of developments in the mutual fund industry,⁵³ Lazard had approached D&B and concluded a series of agreements. A new fund, the Capital Fund, would be organized by Moody's Investors and the Lazard Fund merged into it. The new Capital Fund, after merger, would employ Moody's A&D as investment adviser under a contract similar to the one then in effect between Lazard and the Lazard Fund. Lazard then entered into another agreement with D&B

⁵⁰ It will be submitted that *Insurance Securities* held both that sale of an advisory office at a profit does not violate the relevant fiduciary principles and that common law fiduciary principles were not impliedly incorporated into section 36. See text following note 72 *infra*.

⁵¹ 445 F.2d 1337 (2d Cir. 1971), settled, 336 F. Supp. 84 (S.D.N.Y. 1972). For law review articles discussing *Rosenfeld* see, e.g., Butowsky, Fiduciary Standards of Conduct Revisited—*Moses v. Burgin* and *Rosenfeld v. Black*, 17 N.Y.L.F. 735, 752-66 (1971); Nutt, A Study of Mutual Fund Independent Directors, 120 U. Pa. L. Rev. 179, 202-05, 242-46 (1971); Note, Fiduciary Requirements and the Succession Fee Upon the Change of Mutual Fund Advisers, 85 Harv. L. Rev. 655 (1972); Comment, Mutual Fund Control-Transfer Profits: Congress, the SEC, and *Rosenfeld v. Black*, 58 Va. L. Rev. 371 (1972); Comment, Mutual Fund Advisers, 46 N.Y.U.L. Rev. 1029 (1971).

⁵² 445 F.2d at 1338.

⁵³ The Lazard Fund, as originally set up by Lazard, did not engage in a continuous public offering of its shares. The shrinkage caused by redemptions unaccompanied by sales was expected to be counteracted by an additional offering. However, because mutual fund industry developments accelerated shrinkage to the extent that it would not be likely to be offset by such an offering, Lazard concluded that the Fund would be best served if it were to engage in a continuous offering. Lazard approached D&B in order to facilitate this plan. *Id.* at 1339.

which provided that D&B, upon consummation of the merger, would transfer 75,000 shares of its common stock in consideration of certain covenants made by Lazard.⁵⁴ The plaintiff alleged that the real consideration given by Lazard in return for the 75,000 shares was not the covenants but rather Lazard's assistance in bringing about approval of the merger by the Fund's directors and the consequent appointment of Moody's A&D as investment adviser.⁵⁵

The district court granted summary judgment for the defendants.⁵⁶ But the Court of Appeals for the Second Circuit reversed, holding that an investment company adviser is prohibited from profiting on the transfer of its advisory contract since common law fiduciary principles are impliedly incorporated into the Act.

The Second Circuit began its analysis of *Rosenfeld*, not with an examination of the specific provisions of the Investment Company Act, but with the conclusion that Lazard, in its position as investment adviser, was a fiduciary of the fund and therefore according to established principles of equity was obliged to forgo personal gain from the change of office.

The court rejected the argument that the automatic termination required by section 15(a)(4) ended the fiduciary relationship and that therefore there was no advisory office that Lazard could sell or transfer. The court noted that "the role of Lazard, an organizer of the Fund and its practical control of the proxy machinery used to recommend the approval of Moody's A&D as new adviser, made it quite as active and influential as a corporate president who recommends a successor to his board of directors"⁵⁷

Rosenfeld, citing a law review article⁵⁸ as authority, also rejected the *Insurance Securities* rationale that sections 15(a), (c), and (d) were exclusive remedies and displaced the common law. Noting the policy contained in section 1(b) of the Act, the court stated that "the purpose of § 15 was to furnish the added protection of approval of a new adviser by a majority of the stockholders, not to withdraw safeguards already afforded by equity."⁵⁹

The *Rosenfeld* court's treatment of the legislative history of the 1970 amendments appears less than satisfactory. The court was not able to point to anything in the legislative history to support its position that the common law was incorporated into the Act. Nor did the

⁵⁴ The covenants by Lazard promised inter alia that for a period of five years Lazard would not (a) become associated with another investment company; (b) permit use of the name "Lazard" by such investment company; and (c) act as principal distributor for any open end investment company. *Id.* at 1339-40.

⁵⁵ *Id.* at 1341-42.

⁵⁶ *Rosenfeld v. Black*, 319 F. Supp. 891 (S.D.N.Y. 1970).

⁵⁷ 445 F.2d at 1344.

⁵⁸ Comment, Protecting the Interests of Mutual-Fund Investors in Sales of Management-Corporation Control (or, Policing the Traffic in Other People's Money), 68 *Yale L.J.* 113, 121-28 (1958).

⁵⁹ 445 F.2d at 1344-45.

court adequately address itself to the fact that new express fiduciary duties were contained in amended sections 36(a) and 36(b). *Rosenfeld* stated that "Congress could well have thought it had handled the problem created by *Insurance Securities* by expanding the SEC's power under § 36."⁶⁰

It has been submitted above that amended section 36(a) was not intended to apply to control transfer profits. Section 36(b) explicitly establishes fiduciary duties with respect to compensation paid by the investment company. The *Rosenfeld* court stated that "the content makes plain that Congress did not mean this to be the only fiduciary duty of investment advisers."⁶¹ As has been submitted, to incorporate fiduciary duties into the Act by implication would render the carefully drafted express fiduciary duties in section 36(b) mere surplusage.⁶²

The *Rosenfeld* decision brought a quick negative reaction from the Chairman of the SEC⁶³ and the mutual fund industry,⁶⁴ and dire predictions concerning the potential liability of outgoing investment advisers.⁶⁵ In addition, a number of lawsuits were instituted predicated on the *Rosenfeld* theory.⁶⁶

⁶⁰ Id. at 1348.

⁶¹ Id.

⁶² See text following note 48 supra.

⁶³ SEC Chairman Casey stated: "If [*Rosenfeld*] stands so that anybody starting a new mutual fund or management company will have no prospect of building up any equity, I think it would certainly effectively stop most people from starting new companies As long as we believe that the investment company is performing a useful function . . . then there should be a set of rules which gives the people who perform that economic function the same kind of opportunity of profits and capital that you get in other businesses I think this may take legislation if Judge Friendly's decision is the final law." Casey on the Issues, Institutional Investor 30 (Oct. 1971).

⁶⁴ Charles R. Eaton Jr., president of Eaton & Howard Funds, said, "I personally believe that if you create value, the value is a salable asset. As a matter of principle you ought to have the right to sell what you create." *Newsweek*, Aug. 2, 1971, at 67-69; see also Heinemann, *Mutual Funds Face Crisis*, N.Y. Times, Sept. 12, 1971, § 3, at 1, col. 1.

⁶⁵ One commentator estimated the potential liability of selling managers at \$750 million. *Newsweek*, Aug. 2, 1971, at 67-69. The General Counsel of the Investment Company Institute estimated potential liability involved in litigation at \$600 million. BNA Sec. Reg. & L. Rep. No. 121, at A-3 (Oct. 6, 1971).

⁶⁶ At least sixteen lawsuits have been brought since *Rosenfeld*. *Butowsky, Fiduciary Standards of Conduct Revisited—Moses v. Burgin and Rosenfeld v. Black*, 17 N.Y.L.F. 735, 753 n. 68 (1971).

However, it is difficult to determine how long the *Rosenfeld* opinion will stand as law. In *Newman v. Stein*, 464 F.2d 689 (2d Cir. 1972), Chief Judge Friendly noted the threat of judicial and legislative overruling when faced with an appeal from a settlement in the lower court concerning profits realized by a sale of advisory stock to the public. Plaintiffs sought on behalf of the fund an accounting of profits received by sellers in a public offering of a controlling block of shares in the fund's adviser and principal underwriter. The court noted without expressing approval or disapproval that the defendants had shown a distinction between *Rosenfeld* and *Newman*. The defendants in *Newman* argued that in offering the adviser's stock to the public there was no termination of the adviser but a continuation of a successful one under a new management contract.

The court made a point not argued by appellees or considered in the *Kukman* case. It reasoned that *Rosenfeld* dealt with a company that only acted as the fund's adviser, whereas in *Newman*, the company acted as adviser and principal underwriter. According

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Kukman v. Baum, after reviewing the prior case law and the legislative history of the Act, agreed with *Rosenfeld* on the narrow issue that an investment adviser is a fiduciary with respect to the mutual fund which it advises, and that under common law principles the beneficiary of this relationship is entitled to recover profits on the fiduciary's sale of office.⁶⁷ However, *Kukman* refused to hold that these common law principles are "impliedly incorporated" into the Act and joined the *Insurance Securities* case in ruling that no part of the profits are recoverable by the fund.

The defendants in *Kukman* urged the court not to follow the *Rosenfeld* case because it was factually distinguishable and erroneously decided.⁶⁸ They attempted to distinguish their case from *Rosenfeld* on the ground that *Rosenfeld* had involved a sale of the adviser itself (a partnership), while *Kukman* involved only the sale of controlling stock in the adviser. They argued that since Supervisors never ceased to exist as an entity, the advisory relationship never terminated. The defendants further argued that since there was no change in Supervisors' managing personnel or in the management policies followed by Supervisors, there was no termination of the advisory relationship. The *Kukman* court rejected these arguments and ruled that there was no sound way to distinguish the facts from *Rosenfeld*. The court stated:

[P]ersonnel will eventually be retired or terminated and replaced by those persons in control of the investment management corporation. Further, the promises not to change management policies . . . may well conflict with and be subordinated to the fiduciary's responsibility to alter management policies in light of changing business or economic conditions.⁶⁹

Although the *Rosenfeld* court had explicitly noted that it did not find it necessary to consider whether a sale of a controlling block in a corporate adviser was sufficiently different to warrant a different result,⁷⁰ it is submitted that the *Kukman* court rightly refused to

to the court, the holding of a fiduciary relationship between a fund and its adviser might not necessarily require a similar holding as to an underwriter, and it is arguable that a deduction from the profits should be made to reflect the adviser's distribution activities. *Id.* at 697. A settlement of \$5 million was therefore held reasonable.

⁶⁷ 346 F. Supp. at 61.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ The court noted:

While we do not find it necessary at this time to determine whether the difference between a transaction such as that here before us and the sale of a controlling block in a corporate adviser at a price reflecting the expectation of profits under a renewed contract with the corporation which the sellers were to aid in procuring, is sufficiently substantial to warrant a different result in this latter case, we should not wish to be understood as accepting these views.

445 F.2d at 1346.

distinguish the situation before it from that in *Rosenfeld*. First, the defendants' argument that the advisory relationship between Supervisors and the funds was never terminated is untenable since sections 2(a)(4) and 15 clearly require that a sale of a controlling block of stock in an investment adviser be treated as an assignment resulting in termination of the advisory contract. Furthermore, most advisers are already incorporated. If a prohibition on transfer profits were limited so as not to apply to a sale of a controlling block of stock, those advisers not presently incorporated would simply incorporate when they wish to transfer control. "It would be anomalous, then, if fiduciary standards 'impliedly incorporated' by the Act distinguished between the two cases."⁷¹

The *Kukman* court chose, therefore, to hold *Rosenfeld* indistinguishable on its facts from the case before it and to attack its holding, calling its treatment of the legislative history both superficial and highly subjective.⁷² As was submitted above, *Kukman* was correct in its statutory interpretation and its examination of legislative history. There is no authority for the *Rosenfeld* court's conclusion that the "established prophylactic rule" has been impliedly incorporated into the Act.

It was the position of the *Kukman* court that the common law was not impliedly incorporated into the Act. Yet the *Kukman* court focused primarily on the language in *Insurance Securities* which dealt with the absence of a relationship between the congressional purpose, as set out in the preamble to the Act, and the price paid for shares of an investment adviser. *Kukman* failed to discuss that portion of the *Insurance Securities* opinion dealing with the relation of common law principles to section 36 of the Act. It is submitted that the *Kukman* court could have used this opportunity to clarify the *Insurance Securities* position and thus could have strengthened its own position that the common law is not impliedly incorporated into the Act.

After the *Insurance Securities* court had held that there were no breaches of any fiduciary duties, and that section 36 was inapplicable, it went on to discuss the remedy provided by Congress in section 15(a)(4). The court concluded that section 15(a)(4) was a *specific* remedy and the *only* remedy which was necessary to protect fund shareholders after an assignment of the contract. It could be argued that since the court already had stated its ruling that section 36 was inapplicable, any discussion of the common law principles was mere dictum. It is submitted, however, that because the *Insurance Securities* court took the view that section 15(a)(4) was the only remedy for the specific evil before it, and because the court failed to connect the common law fiduciary equitable principles to section 36, the case could be read as also holding that the common law is not incorporated into

⁷¹ Comment, Mutual Fund Control-Transfer Profits: Congress, the SEC and *Rosenfeld v. Black*, 58 U. Va. L. Rev. 371, 407 (1972).

⁷² 346 F. Supp. at 65.

section 36.⁷³ This suggested reading of the case could have provided precedential support for the *Kukman* court. Indeed, the *Rosenfeld* court had earlier read this portion of the *Insurance Securities* case as "suggesting that in the court's view none of the excess of the price received by the controlling stockholders over the book value of their stock would be recoverable under any circumstances by stockholders of the investment company."⁷⁴ Finally, it should be noted that *Kukman* also failed to examine critically the provision of amended section 36 imposing an express fiduciary duty with respect to compensation paid by an investment company. It is submitted that an analysis of this provision similar to the one outlined above⁷⁵ would also have been helpful to the court's statutory construction.

Although *Kukman* represents the proper interpretation of the amended Act, it is submitted that legislation should be introduced to clarify the issue and to balance properly the interests of fund investors and advisers. Such legislation should protect the fund investors as well as provide compensation for the outgoing advisers. *Rosenfeld* and *Kukman* have raised policy questions that must be answered by Congress.

Shortly before the *Kukman* case was reported, amendments to the Act which would allow sellers to retain profits were proposed by the SEC.⁷⁶ Under these amendments, the outgoing investment adviser would be permitted to receive benefits in connection with the assignment only if no affiliated⁷⁷ person of the advised company was an interested⁷⁸ person in either the outgoing or incoming adviser for five years after the assignment. In addition, the assignment must not impose an unfair burden on the investment company. The receipt by the outgoing adviser, during a two year period after the assignment, of any compensation in connection with certain transactions of the investment company or for services other than bona fide advisory or administrative services would be deemed to impose an unfair burden on the investment company. Also, directors evaluating the terms of an advisory contract would be prohibited from taking into account any consideration which the adviser may have paid in connection with an assignment of the contract.

Representatives of the mutual fund industry argued that the five-year restriction was too harsh and could result in additional costs to the funds because of the need to hire new people not connected with either management company.⁷⁹ Consequently, the original bill was

⁷³ Compare Comment, *supra* note 58, at 120 n.27 (1958); *The Mutual Fund Industry: A Legal Survey*, 44 *Notre Dame Lawyer* 732, 961 (1969); Comment, *supra* note 71, at 380.

⁷⁴ 445 F.2d at 1346.

⁷⁵ See text following note 48 *supra*.

⁷⁶ See [Current] CCH Fed. Sec. L. Rep. No. 428, June 16, 1972, at 12.

⁷⁷ For a definition of "affiliated person" see 15 U.S.C. § 80a-2(a)(3) (1970).

⁷⁸ For a definition of "interested person" see 15 U.S.C. § 80a-2(a)(19) (1970).

⁷⁹ Address by Senator Williams, before the Securities Industries Ass'n Management

modified to require that for three years after the sale of a management company, at least seventy-five percent of the directors would have to consist of persons having no interest in the management company.⁸⁰

It is difficult to predict at this time precisely what legislation will be passed by Congress. It is suggested, however, that any amendment that is adopted should empower a reviewing court to determine the overall fairness of the transaction when the assignment price is in excess of net asset value. This standard would be in addition to the proposed requirement that at least seventy-five percent of the board of directors would have to consist of persons having no interest in the management company. Any test of fairness should also include a determination of the extent to which the sale price was a premium for the use of influence and of the extent to which the price was based on the expectation that the efficiency and reputation of the purchased organization would lead to reinstatement. A court reviewing the sale price could consider such variables as the expertise of the management personnel, the value of any successful investment formula, and whether the management of the fund in question is the only business of the outgoing adviser.

Of course, such a fairness formula may be difficult for a court to develop, requiring painstaking application of business expertise; the difficulty, however, should not discourage a court from examining an overall transaction. Courts have drawn on the talents of experts in balancing competing interests in many other areas of the law. It is submitted that a more equitable result for both investors and advisers would be worth the extra time and effort which this proposal would entail.

In conclusion, the decision in *Kukman* reaffirms the holding in *Insurance Securities* that a mutual fund cannot recover any profit from the sale of a controlling interest in its adviser. *Kukman* also rejects *Rosenfeld* and explicitly holds what *Insurance Securities* suggested: that common law fiduciary principles are not impliedly incorporated into the Act. It is submitted that *Kukman* is correct in its interpretation of the Act. However, congressional action is needed to resolve the judicial conflict. Congress must properly balance the interests of fund investors and advisers and empower the courts to consider the overall fairness of the transaction.

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Conf., Sept. 7, 1972, reprinted in [Current] CCH Fed. Sec. L. Rep. ¶ 78,979, at 82,108-09 (1972).

⁸⁰ Id. at 82,109.