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Securities Regulation - Investment Company Act of 1940. Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971)

Michael D. Horlick

The decision represents a return to the early position that motivation is perhaps too difficult to ascertain. The emphasis in *Griffin* and *Gomillion v. Lightfoot* was interpreted to focus on effect rather than on motivation. Therefore, the Court held that unless pools supplied to one group are denied to another group, the fact that closing is justified upon unsound hypothesis is not a sufficient ground to order pools reopened on an integrated basis.[40] The *Palmer* decision retreats from the clear implication of a growing relevance of motivation in equal protection litigation. The issue considered has potentially significant ramifications.[41] The decision may be interpreted to permit a locality to "avoid by cynical default its constitutional duty to provide desegregated facilities" or to practice such tactics of delay and evasion as to render meaningless the right to desegregated use of municipal recreational facilities.[42]

THOMAS W. WRIGHT

Securities Regulation—INVESTMENT COMPANY ACT OF 1940. *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971).

Plaintiff Moses commenced a derivative action against Fidelity Fund, Inc., two of its affiliated directors and its investment adviser.[1] Plaintiff complained that the affiliated directors had failed to act upon relevant information concerning possible methods by which a portion of the fund-paid portfolio commissions could be recaptured to reduce fund expenses rather than to stimulate fund sales.[2] In addition, plaintiff alleged that affiliated directors had consistently withheld this informa-

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40. *Id.* at 1945-46.

41. *Id.* at 1947 (concurring opinion).

42. Comment, *supra* note 37, at 1237.

1. A brief overview of the internal operations of mutual funds is outlined in Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds,* 29 LAW & CONTEMP. PROB. 777, 780 (1964).

2. Prior to December 5, 1968 when "customer directed give-ups" were abolished on all stock exchanges, the decision as to alternative uses of brokerage commissions on portfolio transactions was seen as one of the major problems in the mutual fund industry. *See* WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS 3, H.R. REP. No. 2274, 87 Cong., 2d Sess. (1962); Note, *The Use of Brokerage Commissions to Promote Mutual Fund Sales: Time to Give Up the "Give-Up,"* 68 Colum. L. Rev. 334 (1968).

tion from unaffiliated directors.[3] Recovery was sought under section 36 of the Investment Company Act of 1940.[4]

The district court dismissed the action.[5] The court of appeals reversed, concluding that the management defendants had breached a fiduciary duty by intentionally pursuing a course of nondisclosure to the unaffiliated directors in dealing with an issue involving a potential conflict of interests.[6]

In litigation dealing with the liability of mutual fund directors, courts have generally resolved the issue by first defining the type of conduct which will impose liability[7] and then finding a statutory or common law basis upon which it may be imposed. Prior to the Investment Company Act of 1940, which contained a statutory prohibition against director misconduct, state courts sought to determine liability by refer-

3. 15 U.S.C. § 80a-10 (1970) provides in part that no more than 60 percent of the directors of a registered investment company may be persons who are investment advisers, affiliated persons of the investment adviser, or officers or employees of the fund.

4. 15 U.S.C. § 80a-35 (1970) provides 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—
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> (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.
>
> If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

5. 316 F. Supp. 31 (D. Mass. 1970).

6. Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971).

7. Authors have assumed different positions on the issue of which field of law should be utilized as the basis for fund director liability. *See, e.g.*, Anderson, *Rights and Obligations in the Mutual Fund: A Source of Law*, 20 VAND. L. REV. 1120 (1967); Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 GEO. WASH. L. REV. 266 (1959); Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L.J. 1258 (1961).

ence to common law fiduciary standards applicable to directors of financial institutions.[8]

Post-1940 decisions, however, have been decided by application of specific sections of the Act,[9] by examination of its legislative history,[10] and by reference to the Act's basic policy statements contained in section 1(b).[11] This section states in part that the national public interest and the interests of investors are adversely affected when investment companies are operated or managed in the interests of directors, officers, and advisers rather than in the interests of the company's security holders.

The case which initially brought section 36 before the courts, *Aldred Investment Trust v. SEC*,[12] examined the mutual fund industry in general and noted the alarming potential for abuse inherent in the mutual fund operation.[13] The court looked at the policies of the Act contained in section 1(b) and concluded that in view of those declarations the congressional intent was to codify the common law fiduciary obligations applicable to officers and directors of investment companies.[14] Thus the court adopted the common law fiduciary concepts and applied them to the mutual fund industry via section 36 in order to provide a statutory remedy for director misconduct.[15]

8. *See* Goodwin v. Simpson, 292 Mass. 148, 197 N.E. 628 (1935); O'Connor v. First National Investors Corp., 163 Va. 908, 177 S.E. 852 (1935); *contra,* Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 410-11, 8 N.E.2d 895, 904 (1937).

9. "Section 36 provides the Commission and fund shareholders with an important instrument for challenging the more serious abuses which might occur in the mutual fund industry. Sections 10 and 15 also impose significant duties on fund directors in connection with the negotiation and renewal of fund advisory and underwriting contracts." Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940,* 20 RUTGERS L. REV. 181, 183 (1966).

In addition, section 37 deals with the conversion of fund assets.

10. The legislative history of the 1940 Act is presented in North, *A Brief History of Federal Investment Company Legislation,* 44 NOTRE DAME LAWYER 677 (1966).

11. 15 U.S.C. § 80a-1(b) (1970).

12. 151 F.2d 254 (1st Cir. 1945), *cert. denied,* 326 U.S. 795 (1946).

13. "An investment company is essentially a liquid aggregation of capital consisting of public savings turned over to the company for investment . . ." 151 F.2d at 260. *See also* Investment Company Institute v. Camp, 274 F. Supp. 624 (D.D.C 1967).

14. 151 F.2d at 260.

15. Specifically the court adopted the statement in Pepper v. Litton, 308 U.S. 295, 311 (1939) that "[h]e who is in such a fiduciary position cannot serve himself first and his *cestuis* second . . . [h]e cannot use his power for his personal advantage and to the detriment of the stockholders . . . ." *See generally* Eisenberg & Phillips, *Mutual Fund Litigation—New Frontiers For The Investment Company Act,* 62 COLUM. L. REV. 73 (1962); Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds,* 115 U. PA. L. REV. 1058 (1967).

The scope and availability of section 36 was by no means settled despite the paucity of litigation during the first fifteen years under the Act. In the 1958 decision of *SEC v. Insurance Securities, Inc.*,[16] the Court of Appeals for the Ninth Circuit decided that an adviser's indirect sale of an investment advisory contract at an amount significantly greater that book value was not a "gross abuse of trust" under section 36 because the Act itself had specifically provided a remedy against such an evil in section 15 (a)(4)—the automatic termination of the contract on assignment. Though the court did speak to the duration of the fiduciary relationship between the fund advisor and the shareholders, the case is of prime importance for its declaration that when the Act provides a specific remedy for an evil, there is no need for a section 36 action and consequently it would be hostile to the legislative intent to assume that such a remedy would be available.[17]

The district court opinion in *Brown v. Bullock*[18] provides some perspective to those seeking to interpret the Act broadly. The court held that the Act's specific grant of powers to the mutual fund management carries with it corresponding duties of diligence. In addition, *Brown* viewed section 36 as "a reservoir of fiduciary obligations imposed upon affiliated persons to prevent gross misconduct or gross abuse of trust not otherwise specifically dealt with in the Act" [19] because at the time the Act was passed "it was not practicable to incorporate specific deterrents for every potential abuse without seriously impeding the operation of the industry." [20] Further, section 36 was seen as the source of a federally created substantive duty—not merely a codification of the fiduciary duties arising under state law—which empowers the federal courts to create a new body of law.[21]

Brouk v. Managed Funds, Inc.,[22] decided contemporaneously with *Brown*, reviewed the legislative history of the Act noting the over-

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

17. *See generally* Greene, *supra* note 7, at 274.

18. 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

19. 194 F. Supp. 238-40 n.1.

20. *Id.*

21. Shareholder suits alleging "gross misconduct or gross abuse of trust" under section 36 have called upon the courts to provide meaningful standards of conduct for directors and have resulted in the emergence of a federal common law of corporations. See Eisenberg & Lehr, *supra* note 9. *See also* Friendly, *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U.L. Rev. 383 (1964); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 Nw. U.L. Rev. 185 (1964).

22. 286 F.2d 901 (8th Cir. 1961).

whelming support[23] of the mutual fund industry for its passage, and concluded in direct conflict with *Brown* that there is no statutory support for an implication approach to director liability.

Moses found an actionable violation of section 36 for non-disclosure to unaffiliated directors in a possible conflict of interest situation. As such, it is a judicial recognition that the so-called independent check to be asserted by an unaffiliated director[24] means very little unless it is exercised after the affiliated members of management, at their own initiative, have provided adequate information concerning potential conflicts of interest.[25] In its approach to section 36, *Moses* has apparently adopted a variation of the implication theory of liability—as *Brown* implied a duty of diligence to make the delegation of a right meaningful, *Moses* has implied a duty of disclosure to make the Act's watchdog mechanisms effective.

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23. To explore fully the background and motivation for the almost unanimous assent to the Act it is necessary to consider the public image problems of the funds during the thirties and the significant increase in public confidence which it was hoped would result from the comprehensive regulatory provisions of the Act. *See generally* Greene, *supra* note 7, at 266 n.2.

24. To give further meaning and to insure the effectiveness of the role played by the unaffiliated director, the 1970 amendments to the Act have tightened the disabling provisions by placing additional restrictions on the background of persons qualified to assume directorial positions.

25. The specific requirement of disclosure was also treated in a 1965 SEC proceeding wherein the Commission voiced strong approval of the policy that investors "be accorded the benefits of responsible and objective observation and consideration of the fund's activities by unaffiliated directors . . ." SEC Securities Exchange Act Release No. 7684, (Aug. 26, 1965); Imperial Financial Servs., Inc., CCH FED. SEC. L. REP. ¶ 77, 287 at 82, 465 (Aug. 26, 1965).