Investment Company Act -- Procedure -- Demand on Shareholders

William H. Cannon

punishment would be achieved by denying such a person the use of the highways and thus sparing innocent victims in the first place. But, however desirable, such a law would be indeed difficult to contrive.

RICHARD L. BURROWS

Investment Company Act—Procedure—Demand on Shareholders

The Investment Company Act of 1940[1] is a statutory attempt to regulate the internal structure and business conduct of investment companies. It specifically authorizes the Securities and Exchange Commission to investigate violations,[2] issue orders,[3] and seek injunctions.[4] A private right of action by the shareholder is not specifically authorized. The case of *Levitt v. Johnson*[5] faced squarely for the first time the problem of the source of the law to be applied in a private suit under the act.

---

[1] 54 Stat. 789, as amended, 15 U.S.C. § 80a (1958), as amended, 15 U.S.C. § 80a (Supp. V, 1963).

[2] 54 Stat. 842 (1940), 15 U.S.C. § 80a-41 (1958).

[3] 54 Stat. 841 (1940), 15 U.S.C. § 80a-37 (1958); 54 Stat. 842 (1940), 15 U.S.C. § 80a-39 (1958).

[4] 54 Stat. 841 (1940), 15 U.S.C. § 80a-35 (1958); 54 Stat. 842 (1940), 15 U.S.C. § 80a-41 (1958).

[5] 334 F.2d 815 (1st Cir. 1964), *reversing* 222 F. Supp. 805 (D. Mass. 1963). The plaintiff, a minority shareholder, brought a derivative suit under the Investment Company Act of 1940, against the directors of the Fidelity Capital Fund, Inc., a Massachusetts corporation, on behalf of himself and other stockholders. The allegations generally were that the directors had paid excessive fees that constituted a waste of corporate assets. As to the condition precedent of making a demand on shareholders, the plaintiff alleged as excuse for failure to make demand that

> the Fund has more than 48,000 stockholders scattered all over the United States whose identity is subject to frequent changes. A demand upon the stockholders to take action would cast an unconscionable financial burden on the plaintiff in that the plaintiff would have to solicit proxies from all of the stockholders residing in every State of the Union and foreign countries. It would involve the conduct of a proxy fight, a proxy fight which would entail prohibitive expenses and would cause undue loss of time with the danger that the claims alleged might be barred by the Statute of Limitations.

222 F. Supp. at 807. The court then ruled that the Massachusetts law was to be applied; it provides that it "is only when the complaint alleges that the majority are corrupt or are otherwise incapable of acting in good faith that the demand upon the body of stockholders may be excused." *Id.* at 812. The circuit court reversed on the grounds that the application of the Massachusetts rule "negates the intendment of the act and underestimates the role to be played by the federal courts in the implementation of national regulatory legislation." 334 F.2d at 819.

In prior decisions, the state and federal courts have construed the statute where possible and have applied the law of the state where the transaction arose to fill the interstices; they have not questioned the source of the law applied since there has been no conflict between federal law and state law.[6]

In *Levitt,* the First Circuit Court of Appeals reversed the ruling of the District Court of Massachusetts which had applied local law imposing very strict requirements of demand on other shareholders before bringing a derivative action.[7] The circuit court said that the application of Massachusetts law would serve to substantially stiffen the conditions precedent to bringing suit under the act. This would contravene the intent of the act which "is directed to 'the national public interest and the interest of investors * * * adversely affected,' and its 'purposes * * * with which [its] provisions * * * shall be interpreted, are to mitigate and, *so far as is feasible, to eliminate the conditions enumerated.*' "[8]

In saying, "we do not see how it can be gainsaid that any substantial stiffening of the conditions precedent to the bringing of stockholders' suits above *normal* requirements would conflict with this broad declaration [of policy],"[9] the court established a vague precedent. Under the *Levitt* decision, is state law to be adopted as long as it does not thwart the purposes of the act, or is the vast repository of the federal common law to be the source of the substantive principles sought? What are the *normal* requirements of conditions precedent to bringing a shareholder's derivative suit? In the past, both state and federal courts have applied state law under the act, thereby adopting, whether consciously or unconsciously, the applicable state law as federal law.[10] Up to now this has been ade-

[6] For examples of the treatment of the act in prior cases, see Taussig v. Wellington Fund, Inc., 187 F. Supp. 179 (D. Del. 1960), *aff'd,* 313 F.2d 472 (3d Cir.), *cert. denied,* 374 U.S. 806 (1963); Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963); Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961); Lutz v. Boas, 171 A.2d 381 (Del. Ch. 1961); Meiselman v. Eberstadt, 170 A.2d 720 (Del. Ch. 1961).

[7] See note 5 *supra.* The Massachusetts rule as construed by the district court, 222 F. Supp. at 812, is not a majority rule, if it is followed by any other jurisdiction at all. For a discussion of the function of demand on shareholders and directors, and the status of the state law in regard to demand, see Note, 73 HARV. L. REV. 746 (1960); Comment, 33 N.Y.U.L. REV. 71 (1958).

[8] 334 F.2d at 819, *quoting* 54 Stat. 789 (1940), 15 U.S.C. § 80a-1 (1958).

[9] 334 F.2d at 819. (Emphasis added.)

[10] See note 6 *supra.*

quate. In *Levitt,* however, at least one exception has arisen to the blanket adoption of state law, bringing the validity of that practice up for review. The following will be an attempt to evaluate the merits of the approaches available, and to determine which approach should be followed.

Some state[11] and circuit court[12] decisions have interpreted the act to give a private right of action by way of a derivative suit,[13] and the courts in *Levitt* accepted that premise.[14] But that issue has not been passed upon by the United States Supreme Court,[15] and if certiorari is granted in this case,[16] it will certainly be a key issue. No attempt is made to discuss the merits of this issue, and for the purposes of this note, the assumption is made that there is at least a derivative right of action by shareholders under the statute.[17]

It should be noted at the outset that the *Erie*[18] rule is not directly applicable[19] in *Levitt* because jurisdiction is not based on diversity of citizenship, but is granted by the act.[20] The court must construe the act to determine the rights of the parties, making this a federal

[11] Lutz v. Boas, 171 A.2d 381 (Del. Ch. 1961).

[12] Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961).

[13] See 54 Stat. 844 (1940), 15 U.S.C. 80a-43 (1958). This section gives concurrent jurisdiction to state and federal courts of all suits in equity and actions at law brought to enforce any liability or duty created by the act. This lends weight to the idea that the intention was to give a private right of action, but one decision, Brouk v. Managed Funds, Inc., 286 F.2d 901 (8th Cir. 1961), *dismissed as moot,* 369 U.S. 424 (1962), has specifically denied any private right under the act. See also Eisenberg & Phillips, *Mutual Fund Litigation-New Frontiers of the Investment Company Act,* 62 COLUM. L. REV. 72, 91 (1962); Note, 1961 DUKE B.J. 421.

[14] 222 F. Supp. at 807.

[15] Of the recent cases, Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961), was not appealed, and Brouk v. Managed Funds, Inc., 286 F.2d 901 (8th Cir. 1961), was dismissed as moot, 369 U.S. 424 (1962).

[16] *Petition for cert. filed,* 33 U.S.L. WEEK 3123 (U.S. Oct. 13, 1964) (No. 559).

[17] See note 13 *supra.*

[18] Erie R.R. v. Tompkins, 304 U.S. 64 (1938). This case established that in diversity of citizenship cases, the law of the state in which the suit arises is to be applied. The case has undergone some redefining. Byrd v. Blue Ridge Rural Elec. Cooperative, Inc., 356 U.S. 525 (1958); Guaranty Trust Co. v. York, 326 U.S. 99 (1945). But the general proposition still applies.

[19] For discussion of *Erie* rationale in non-diversity litigation, see Hill, *State Procedural Law in Federal Non-diversity Litigation,* 69 HARV. L. REV. 66 (1955); Mishkin, *The Variousness of Federal Law,* 105 U. PA. L. REV. 797 (1957).

[20] 54 Stat. 844 (1940), 15 U.S.C. § 80a-43 (1958).

question case, in which federal, not state law is applied.[21] A problem immediately arises because there are no decisions in the federal courts to determine the substantive rights in a derivative suit under this statute. Therefore, the decisions as to the law to be adopted under the act is a policy decision based upon principles of congressional intent, convenience and certainty of administration, and a proper deference to state substantive principles.

The court of appeals was correct in reversing the adoption of state law by the district court if it conflicted with the intention of the statute. In federal question cases, the federal court may adopt state law to fill the interstices, but they are not required to do so if it is against reason or federal policy, and especially if it would substantially negate the intendment of the act.[22]

Where implementation of the statute is not definitely prescribed in the statute, the procedure of the federal and state courts of adopting the state law enforcing rights under the statute has advantages of relative simplicity of administration and relative certainty of result. By adopting state law, the courts have a more or less established body of law on which to draw, but in applying federal law not based on the law of the state of jurisdiction, they must look to the federal common law.[23] If there are no prior decisions in point, the end result is based on the declaration of policy in the statute, a judge's interpretation of legislative intent, uncertain analogies, and a declaration of what the "general" law is. In such cases the decision may be just, but with all the undecided variables, an educated guess of what the outcome will be is nearly impossible.

Added to simplicity of administration and certainty of result, the adoption of state law would be in line with the idea of recognizing state sovereignty and maximum deference to state substantive law as in the rationale of *Erie* and its successors.[24]

Additional factors to be considered are the diversity of the law

[21] Clearfield Trust Co. v. United States, 318 U.S. 363 (1943). See also 1 BARRON & HOLTZOFF, FEDERAL PRACTICE AND PROCEDURE § 25 (Wright ed. 1960); WRIGHT, FEDERAL COURTS § 17 (1963).

[22] Clearfield Trust Co. v. United States, *supra* note 21, at 367; Board of County Comm'rs v. United States, 308 U.S. 343, 351-52 (1939). See also Mishkin, *supra* note 19, at 802.

[23] The federal common law is that body of law that is built from construction of the Constitution, legislation, or treaties of the United States. D'Oench, Duhme & Co. v. Federal Deposit Ins. Corp., 315 U.S. 447, 471-72 (1942) (Jackson, J., concurring).

[24] See Hill, *supra* note 19, at 71; Mishkin, *supra* note 19, at 810.

from state to state, the number of states that have settled the issue, and whether or not the state law serves the purpose of the act. If the law is uniform and well settled in most states there is no real problem, since results would be predictable and uniform whether the court adopted state law or established a uniform federal common law based on the aggregate of the state laws. As the state laws become more diverse, the argument for predictability would support the application of state law while that for uniformity would not. Where few states have settled the issue, the argument for uniformity becomes stronger. There is very little uniformity in the requirements for demand on shareholders.[25] This might indicate that there is need for a uniform rule, but it also shows that there is little uniformity from which the courts can derive such a rule. It would seem obvious that so long as federal legislation is being construed, any state rule that negated the purpose of this act could not be applied.

As intimated above, and as the holding of *Levitt* points out, the state law cannot be adopted in federal question cases where its application would clearly block the purposes of the statute. Assuming, but not yet admitting, that the adoption of the state law is the correct policy, this restriction must be added to it. In simplest terms, this policy would be that state law is to be adopted as far as it does not thwart the purposes of the statute. All the preceding considerations for and against the application of state law apply, but here an additional problem arises. This problem is how to determine just what state law serves the purposes of the statute, and what impedes it.

In the context of *Levitt,* the district court determined that demand on 48,000 shareholders was not to be excused, even where their identity was subject to frequent change and they were spread all over the United States and foreign countries, and which demand would result in an extremely expensive proxy fight. Is the act thwarted by this rule? Such a requirement in practice would certainly prevent shareholders from going to the expense and trouble of trying to enforce compliance with the fiduciary standards imposed on directors by the act. Accepting the premise that a private right of action is authorized, and that the intent of the act is to impose a more stringent regulation over directors' actions than under common law,

[25] See Note, 73 HARV. L. REV. 746, 747 (1960).

then it would certainly appear that the Massachusetts rule would severely limit the purpose of the act.

All conditions precedent to bringing a derivative suit more or less restrict its availability. It is considered an extraordinary remedy in that all intra-corporate remedies should first be exhausted; hence the requirement of demand on directors and shareholders to bring suit.[26] *Levitt* recognized the value of these restrictions by saying that normal requirements of derivative suits do not thwart the act.[27] It is submitted that another factor, admittedly no less vague yet distinguishable, is that the requirement must be a reasonable one. A normal requirement is probably one that is generally accepted among the states, whereas an unreasonable requirement would be one that, in the light of modern corporate practice, the number of shareholders, the evil sought to be corrected, and the validity of the suit, is prohibitive beyond its usefulness in preventing frivolous or strike suits. Some states require a bond by the plaintiff in a derivative suit to prevent frivolous or strike suits. It is submitted that such a requirement is reasonable and normal within the meaning of *Levitt*.

There is serious disagreement among states as to what are conditions precedent for bringing derivative suits, and what constitutes an adequate excuse for failure to perform them.[28] It would be useless to speculate as to each requirement, but it is submitted that if the principle under discussion is the one to be accepted by the courts, only the most restrictive and unreasonable would not be *normal* requirements under the act, especially in light of the fact that the right to bring a private suit under the act is still arguable.[29] Obviously legislative intent does not show on the face of the act so plainly that it can be said that any restriction on bringing suit under the act contravenes its intent. Absent a broader and more authoritative declaration of policy under the act, it is submitted that *Levitt* should not be extended to any great degree, if at all, beyond its facts.

[26] Hawes v. Oakland, 104 U.S. 450 (1881). See Note, 73 HARV. L. REV. 746, 748 (1960).

[27] 334 F.2d at 819.

[28] See Note, 73 HARV. L. REV. 746, 754 (1960).

[29] If it is not evident from the act that there is a private right, it follows that it is not evident that all restrictions on bringing derivative suits are to be abolished. Accepting the premise that there is a private right, however, it is only logical that very restrictive conditions that amount to a denial of that right should not be applied.

Absent a change in policy brought about by the Supreme Court or by remedial legislation, convenience and the weight of authority will probably perpetuate the principle that the courts will adopt the state conditions precedent for derivative suits brought under the act unless they impose serious restrictions. Nevertheless, it may be helpful to mention the other possible approaches.

Theoretically, the courts could accept the policy of adopting those requirements for derivative suits that are common practice among the states and that would not defeat the act. This is the federal common law approach. Comparing this policy with that of adopting state law except where it negates the purpose of the act, the body of the common law would be built up from case to case throughout all jurisdictions; and a case in one jurisdiction establishing a substantive principle would be strong authority in another jurisdiction. But where the existing state law is adopted, the effect is to subtract the necessary exceptions from the existing law; and only those exceptions to state law would be authority from one jurisdiction to another. It is clear that the better policy for the sake of certainty and convenience of administration would be to adopt the state law except where it thwarts the purpose of the act, rather than to attempt to build a substantive federal common law of requirements for bringing a derivative suit.

In spite of the foregoing argument, there are cogent and self-evident reasons[30] for having a uniform national policy of admin-

[30] Uniformity under a federal statute is usually desirable so that results will not vary with the accident of jurisdiction. However, by application of state derivative requirements, it does not seem that the results will vary significantly from jurisdiction to jurisdiction although the plaintiff may be faced with different qualifying requirements before bringing a derivative suit. As seen in *Levitt,* if these requirements are not normal or reasonable as suggested by this note, then the court may strike the offensive requirement. Once past the requirements to get into court by way of a derivative suit, the construction of the statute as to the merits of the claim undoubtedly should be derived from a judicially declared uniform federal rule. The fact that *Levitt* is the first case since 1940 to raise the question of whether state law of conditions precedent is to be applied shows that there is no pressing need for a uniform policy covering this essentially procedural question, since the application of state law has been sufficient in the past and has adequately served to qualify shareholders to bring a derivative suit.

The adoption of state law in this instance is not primarily to protect state sovereignty or a state interest, because the states probably do not have an interest in securities regulation that is separate from or paramount to the federal interest. The reason for adopting the state law is simply that there is a body of law on which to draw that serves the purpose of the act except in certain limited situations, such as the one in *Levitt.*

istration under the Investment Company Act; but unless the policy is created fully formed, the uncertainties during the growth period outweigh the arguments for uniformity. An extensive and definitive statement of policy from the Supreme Court could alleviate much of the uncertainty; but it does not seem that this is the function of the Court, notwithstanding the recent decision of *J. I. Case Co. v. Borak*.[31] Judicial legislation of this degree should be avoided, especially when there is a reasonable alternative. It is suggested that there is a reasonable alternative in the continuation of the policy of adopting state law, thereby confining the power of the Court to a declaration of policy of what substantive principles thwart the purpose of the act.

The acceptable means for creating this uniform or certain policy is by legislation.[32] If Congress decides that a private right of action was intended or is needed, that could be specifically stated and the means established by which it is to be asserted. Congress could say that the shareholder has only a derivative right of action, or that he has a direct right, or both. It could then establish the law or specify that the state law be applied. This would be the ideal solution to the problem, but it is unlikely that this will come about until the law becomes hopelessly muddled or Congress decides that the act, as interpreted by the courts, does not accomplish its purpose.

The Supreme Court could close out all speculation by declaring that there is to be no private right of action. This cannot be relied

---

As an argument for the adoption of a uniform judge-made policy, the argument in Textile Workers Union v. Lincoln Mills, 353 U.S. 448 (1957), is persuasive; but it is not compelling because the need for a uniform federal policy of conditions precedent for a derivative suit under the Investment Company Act is not as pressing as that needed to be filled under the Taft-Hartley Act, § 301(a). Labor Management Relations Act, 61 Stat. 156 (1947), 29 U.S.C. § 185(a) (1958). As a practical matter, it is doubtful whether the question decided in *Levitt* will arise again outside Massachusetts. Accordingly, the opportunity to build a reliable body of judge-made law will probably not present itself, thus leaving the state of the law in limbo.

[31] 377 U.S. 426 (1964). The Court in this case gave a direct private right of action under the Securities Exchange Act of 1934, § 14(a), 48 Stat. 895 (1934), 15 U.S.C. § 78n (a) (1958). The act had not provided for one. The Court said that it had the power to effectuate the purposes of the act where Congress had not specifically done so.

[32] Congress at least has a hint that the act has not curbed the abuses at which it was aimed, and it authorized a study of the effect of the act. Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. Doc. No. 2274, 87th Cong., 2d Sess. (1962).

upon any more than Congressional clarification. Accordingly, lawyers and judges must live with the situation as it stands.

The most probable and under the circumstances the most reasonable approach is that taken by *Levitt* and the previous decisions under the act. That approach is to adopt the law of the state in its entirety, except where the requirement for demand on shareholders or other conditions precedent to bringing of the derivative suit so seriously and unreasonably burden the shareholder as to prevent him from bringing an otherwise bona fide suit under the act.

Following this rationale, *Levitt* will probably have very little effect outside of Massachusetts, but it will have a substantial effect in Massachusetts, the home of many investment companies. The effect will be to make the Investment Company Act available to shareholders who wish to attempt to enforce its provisions against directors without having to make a demand on the multitude of shareholders who are generally not interested in the internal operation of the company.

WILLIAM H. CANNON

Procedural Rules—Emergency—Judge's Discretion

The recent case of *Application of President & Directors of Georgetown College, Inc.*[1] tests the powers of a judge to violate usual procedural rules in an emergency situation. A patient, who had voluntarily submitted herself for treatment at Georgetown Hospital, refused to authorize blood transfusions which the doctors believed necessary to save her life. After the patient's husband had also refused to authorize the transfusions, the hospital's attorneys presented to a federal district judge an order authorizing transfusions "necessary to save her life,"[2] and requested him to sign it. The judge denied the order without comment, and the attorneys then orally petitioned a single judge of the District of Columbia Court of Appeals, Judge Skelly Wright, in chambers to sign the order. Judge Wright went to the hospital, talked with the patient and her husband, and discovered them adamant in their conviction that blood transfusions amount to "drinking blood," a practice strongly condemned by their religious sect, the Jehovah's Witnesses. He advised the patient's husband to obtain counsel, but after making a telephone

[1] 331 F.2d 1000 (D.C. Cir. 1964).
[2] *Id.* at 1001 n.1.