

Corporations—Derivative Action—Demand on Shareholders—Excuse.—

Levitt v. Johnson.¹—Fidelity Capital Fund, Inc., a Massachusetts corporation, entered into management contracts with several investment advisory corporations, whereby it paid them fees according to a fixed percentage of Fidelity's capital assets. Levitt, a minority stockholder of Fidelity brought this derivative action alleging (1) that several of Fidelity's directors were affiliated with the advisory corporations, (2) that the fees voted by Fidelity's directors were excessive, and (3) that the directors had thereby breached their fiduciary duty to Fidelity in violation of the Investment Company Act.² Because the corporation had 48,000 shareholders, plaintiff felt that to poll them as a condition precedent to his bringing a derivative action would be futile. Rule 23(b) of the Federal Rules of Civil Procedure requires that the absence of a demand on stockholders must be explained in the pleadings. The District Court for the District of Massachusetts dismissed the action and found that, although an excuse appeared in plaintiff's pleadings, it was not sufficient under controlling Massachusetts law which, the court felt, required making a demand on shareholders, no matter how numerous.³ On appeal, the First Circuit vacated the judgment below and HELD: if Massachusetts law on excusing the demand on shareholders were as strict as the lower court believed, it would not control because it would conflict with the purpose of the Investment Company Act.

The democratic structure of a corporation ordinarily requires that no action be taken allegedly on behalf of the corporation by a single stockholder without the approval of a majority of the stockholders.⁴ If a minority shareholder believes that the corporation needs protection, he must first seek action from the directors⁵ unless they themselves are the wrongdoers and a demand on them would be futile.⁶ If they refuse, the minority shareholder generally must then petition his fellow shareholders to take appropriate action unless the alleged wrong cannot be ratified by a majority of them.⁷ Al-

¹ 334 F.2d 815 (1st Cir. 1964), cert. denied, 85 S. Ct. 649 (1965).

² 54 Stat. 789 (1940), 15 U.S.C. § 80a-1 (1958).

Section 37 of the act declares in part:

Whoever steals, unlawfully abstracts, unlawfully and wilfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime. . . .

A definition of an affiliated person is found in § 2(a)(3):

Affiliated person of another person means . . . (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person . . . (E) if such other person is . . . any investment adviser . . . or any member of an advisory board [of an investment company]. . . .

³ *Levitt v. Johnson*, 222 F. Supp. 805 (D. Mass. 1963).

⁴ See *Pomerantz v. Clark*, 101 F. Supp. 341, 346 (D. Mass. 1951).

⁵ *Hawes v. Oakland*, 104 U.S. 450, 460, 461 (1882); *Halprin v. Babbitt*, 303 F.2d 138, 140 (1st Cir. 1962); *Bartlett v. New York, N.H. & H.R.R.*, 221 Mass. 530, 534, 109 N.E. 452, 454 (1915).

⁶ *Carroll v. New York, N.H. & H.R.R.*, 141 F. Supp. 456 (D. Mass. 1956); *Pomerantz v. Clark*, supra note 4; *Citin v. Greater N.Y. Indus., Inc.*, 79 F. Supp. 692 (S.D.N.Y. 1948).

⁷ *Hyams v. Calumet & Hecla Mining Co.*, 221 Fed. 529 (6th Cir. 1915); *Continental*

though generally obligatory, courts vary in permitting non-performance of this requirement. For example, one court required demand on 8 million shareholders.⁸ Some jurisdictions leave the determination of an excuse to the discretion of the trial judge.⁹ And at least one state by statute has abolished the requirement of making demand upon shareholders.¹⁰

Since the purpose of making this demand is to obtain balanced consideration of the issues, the larger the number of shareholders, the less likely is the possibility of getting such full consideration.¹¹ Thus, since the purpose of the demand cannot be reasonably fulfilled where the number of stockholders is large, some courts have excused the requirement of demand upon them as a condition precedent to a derivative action.¹²

Since the instant case involved a Massachusetts corporation, the district court felt compelled to consult Massachusetts law relative to the demand requirement and its excuses.¹³ Massachusetts, like the majority of states, requires a demand upon shareholders, as a condition precedent to a derivative action, when directors have refused to act.¹⁴ Thus in *Dunphy v. Traveller Newspaper Ass'n*,¹⁵ the Massachusetts court, restating the general rule enunciated in *Hawes v. Oakland*,¹⁶ stated:

Sec. Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912); but see S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., 326 Mass. 99, 93 N.E.2d 241 (1950).

⁸ Pomerantz v. Clark, supra note 4.

⁹ Berg v. Cincinnati, N. & C. Ry., 56 F. Supp. 842 (E.D. Ky. 1944); Escoett v. Alderess Country Club, 16 N.J. 438, 109 A.2d 277 (1954).

¹⁰ Ohio Rev. Code Ann. § 2307.311 (1964):

In any action or proceeding brought or maintained by an owner . . . of shares in the right of a domestic or foreign corporation, the plaintiff . . . must . . . allege with particularity his efforts to secure from the directors such action as he desires and the reasons for failure to obtain such action, or the reasons for not making such effort.

The Comment to this section states:

[U]nder the laws of some states, a shareholder, in order to qualify, must aver and prove with particularity the efforts he made to secure corporate action from the directors and from the shareholders. In the above section there is no requirement that the shareholder make any effort to obtain action by the other shareholders. It is sufficient that he aver and prove that he endeavored to obtain action by the directors, because the matter of determining whether or not to bring suit . . . is normally a question for the directors to decide.

¹¹ Levitt v. Johnson, supra note 1, at 818.

¹² Gottesman v. General Motors Corp., 268 F.2d 194 (2d Cir. 1959) (excused demand on 667,000 shareholders); Citrin v. Greater N.Y. Indus., Inc., supra note 6, and Berg v. Cincinnati N. & C. Ry., supra note 9 (both cases excused demand on numerous shareholders); Slutzker v. Rieber, 132 N.J. Eq. 406, 28 A.2d 525 (1942) (excused demand, assuming stockholders numerous). But see Bruce & Co. v. Bothwell, 8 F.R.D. 45 (S.D.N.Y. 1948) (required demand on 20,000 shareholders holding 9,000,000 shares); but where just the number of shares and not the number of shareholders is pleaded as an excuse, some courts have required demand. See Haffer v. Voit, 219 F.2d 704 (6th Cir. 1955); Levitan v. Stout, 97 F. Supp. 105 (W.D. Ky. 1951); Varanelli v. Wood, 9 F.R.D. 61 (S.D.N.Y. 1949).

¹³ Levitt v. Johnson, supra note 3, at 808, 809.

¹⁴ S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., supra note 7; Bartlett v. New York, N.H. & H.R.R., supra note 5; Dunphy v. Traveller Newspaper Ass'n, 146 Mass. 495, 16 N.E. 426 (1888).

¹⁵ Supra note 14.

¹⁶ Supra note 5; the Hawes decision is the basis of Rule 23(b) of the F.R.C.P.; see 50 Va. L. Rev. 365 (1964).

Courts of equity are swift to protect helpless minorities of stockholders of corporations from the oppression and fraud of majorities. But the legal relations into which the members of a corporation enter require them to seek redress for supposed wrongs done them as stockholders from its officers, and from the corporation itself, before applying elsewhere.¹⁷

The court then dismissed the action partly for failure to make a demand upon the directors, and ruled that where the alleged wrongdoers are themselves the controlling majority of shareholders, the minority shareholder need not make a demand on them. Again in *Bartlett v. New York, N.H. & H. R.R.*¹⁸ the court simply reiterated *Dunphy*, and dismissed the derivative action for failure to make a sufficient demand on the directors. The court rested on this failure and did not reach the question of demand on large numbers of shareholders.

Not until *S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp.*,¹⁹ did the excuse from the requirement of demand upon shareholders vary from the majority states. In *Solomont*, which involved a corporation composed of a small number of shareholders, the court held that a majority of shareholders, uninvolved in the alleged wrong, after due consideration of the issues, can bar a derivative action if they believe it would be in the best interest of the corporation. Thus, even when the shareholders could not ratify the wrong, a demand upon them is still required.²⁰ Such a requirement when the corporation consists of a small number of shareholders is reasonable.²¹ One effect of this decision was to remove from possible available excuses in Massachusetts for not making demand upon shareholders that of the non-ratifiability of the act by them.²²

Recently, the Massachusetts court in *Datz v. Keller*,²³ dismissed plaintiff's derivative action for failure to plead any demand or excuse therefrom upon shareholders. Thus, like Rule 23(b) of the Federal Rules of Civil Procedure, Massachusetts requires this demand or the pleading of an "adequate excuse" for not making it. The *Datz* court restated that where an impartial corporate forum is unavailable because it is controlled by the wrongdoers, a minority stockholder is excused from the demand on shareholders. This control of the forum by the wrongdoers or the need for immediate action, are the only declared excuses, in Massachusetts, from the demand.²⁴ Specifically, the Massachusetts courts are silent on whether a large number of shareholders, if pleaded as an excuse, would excuse demand.

¹⁷ Supra note 14, at 496-97, 16 N.E. at 430.

¹⁸ Supra note 5.

¹⁹ Supra note 7.

²⁰ Id. at 113, 93 N.E.2d at 248.

²¹ See Halprin v. Babbitt, supra note 5.

²² But see *Rogers v. American Can Co.*, 305 F.2d 297 (3d Cir. 1962); *Continental Sec. Co. v. Belmont*, supra note 7.

²³ 1964 Mass. Adv. Sh. 491, 196 N.E.2d 922 (1964).

²⁴ *Datz v. Keller*, supra note 23; *S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp.*, supra note 7; *Bartlett v. New York, N.H. & H.R.R.*, supra note 5; *Von Arnim v. American Tube Works*, 188 Mass. 515, 74 N.E. 680 (1905); *Brewer v. Boston Theatre*, 104 Mass. 378 (1870).

Although the state court is silent on the issue of numbers as an excuse, the United States District Court for the District of Massachusetts, applying its understanding of Massachusetts law, has adopted a stern approach to allowing excuses for making demand based on numbers. In *Pomerantz v. Clark*,²⁵ a diversity action, plaintiff pleaded the futility of making demand on several million policyholders. The district court held that, since the shareholders might vote to bar the suit, a large number of shareholders is no excuse, in Massachusetts, for not making the demand.²⁶ Without balancing the burden upon a minority shareholder of requiring a demand on large numbers of shareholders against the futility of reasonably expecting the shareholders in a large corporation to respond as the shareholders in the small *Solomont* corporation did, the district court required a demand upon eight million policyholders of the John Hancock Life Insurance Co. Admitting that a large number of shareholders lessens the likelihood of their informed participation in corporate affairs, the district court, citing the dictum in *Bartlett* as authority for requiring demand on a large number of shareholders, concluded that where the shareholders are not controlled by the wrongdoers, a demand is always required, regardless of their number, because they might reasonably decide to bar the suit.

In *Carroll v. New York, N.H. & H.R.R.*,²⁷ another diversity action involving a large number of shareholders, the district court, citing *Pomerantz* and *Solomont*, again held that merely because the number of shareholders was large, this would not excuse demand. But, the court continued, even when a majority of the shareholders participating in a shareholders' meeting might be corruptly allied with the wrongdoers, this would still not excuse demand upon a majority of all the shareholders.²⁸ In the instant case, the district court followed its same strict construction of the Massachusetts requirement by holding that a demand on 48,000 shareholders was necessary for standing to sue, even though the action rested on the Investment Company Act rather than diversity of citizenship which was the basis of jurisdiction in *Pomerantz* and *Carroll*.²⁹

These prior decisions by the district court raise the question of the validity of the court's interpretation of Massachusetts law as holding a large number of shareholders immaterial in determining an excuse from a demand upon them. This view has been criticized as being both unrealistic³⁰ and probably contrary to Massachusetts law.³¹ As pointed out in *Halprin v. Babbitt*,³² the purpose of a demand upon shareholders is to evoke full and fair consideration of the issues. In *Halprin*, the First Circuit required a demand by a minority shareholder upon the controlling shareholder although the board of directors elected by this majority shareholder had refused to act. In the instant case, the court said:

²⁵ Supra note 4.

²⁶ Id. at 343.

²⁷ Supra note 6.

²⁸ Id. at 458.

²⁹ Infra note 37 and accompanying text.

³⁰ See Note, 73 Harv. L. Rev. 746 (1960).

³¹ See Note, 65 Harv. L. Rev. 1075 (1952).

³² Supra note 5.

If their number is small, as in Halprin, and the minority could reasonably be expected to put its case before them, it should be obliged to do so.³³

Thus, the plaintiff should be required to make the demand only when it would be reasonable to expect his fellow shareholders to give the required full consideration of the issues; otherwise it would be futile to require it. Where large numbers of shareholders are involved, as in the instant case, a demand should be excused, for "not only would such a burden be enormous, but no disclosure that plaintiff could be expected to make would be likely to persuade a majority to take over the action, or, conversely, permit an informed decision by the majority that the action be not instituted."³⁴

In the instant case, the circuit court, in vacating and remanding for reconsideration of the need for demand upon shareholders under the circumstances, suggested that the requirement under Massachusetts law was not as strict as the district court understood it to be. Alternatively, the court found that if Massachusetts law were that stern, it would not apply in the instant case because it would defeat the purposes of the Investment Company Act. One purpose is "to mitigate and . . . eliminate" inter-locking directorates of investment funds controlled by their investment advisors which result in payments of excessive fees by the funds to the advisors.³⁵ Thus, to burden a minority shareholder with the requirement that he make a demand upon the numerous shareholders of investment companies conflicts with this purpose of the act for, in some cases, it could bar the action.³⁶

Although the circuit court was aware of the need for an applicable law, if Massachusetts law did not apply, it did not expressly find that some form of "federal common law" should be applied.³⁷ But, in a similar action based on the act, the Second Circuit, citing *Textile Workers Union of America v. Lincoln Mills*,³⁸ said:

Indication of Congressional intent to create a body of federal law giving rise to a distinctive federal claim has been found from evidence less compelling than [in the Investment Company Act.]³⁹

³³ Supra note 1, at 818.

³⁴ Ibid.

³⁵ 54 Stat. 789 (1940), 15 U.S.C. § 80a-1(b) (1958). See Eisenberg & Phillips, *Mutual Fund Litigation—New Frontiers for the Investment Company Act*, 62 Colum. L. Rev. 73 (1962).

³⁶ As the court in *Pomerantz v. Clark*, supra note 4, at 346, stated:

To prevent these minority members from suing until they have acquired the support of a majority . . . is in most cases to throttle them. They must move against inevitable inertia which always favors the *status quo*, the respectable and the powerful, particularly if, regardless of wrongdoing, a particular company has prospered. They rarely have large funds at their command to circularize and arouse their fellows.

³⁷ For increasing application of and problems concerning "federal common law" see Notes, 6 B.C. Ind. & Com. L. Rev. 331 (1965); 74 Yale L.J. 325 (1964); 50 Va. L. Rev. 365 (1964); 69 Yale L.J. 1428 (1960).

³⁸ 353 U.S. 448 (1957).

³⁹ *Brown v. Bullock*, 294 F.2d 415, 421 (2d Cir. 1961).

In *Lincoln Mills*,⁴⁰ which involved labor legislation,⁴¹ the Supreme Court said:

[the lack of] express statutory sanction . . . will be solved by looking at the policy of the legislation and fashioning a remedy that will effectuate that policy. The range of judicial inventiveness will be determined by the nature of the problem. . . . [For] it is not uncommon for federal courts to fashion federal law where federal rights are concerned.⁴²

Furthermore, in actions based on other federal statutes, federal courts, interpreting congressional intent, have created federal rules in furtherance of the intentment of the particular act.⁴³

Further support for the creation of a "federal common law," if Massachusetts law is inapplicable, is found analogously in *J. I. Case Co. v. Borak*.⁴⁴ There, the state law was silent on any available relief to the plaintiff, a shareholder suing to void a merger obtained by misrepresentation in proxies in violation of the Securities Exchange Act of 1934.⁴⁵ Similarly, in the instant case, Massachusetts courts are silent on whether a large number of shareholders is an excuse. In *Borak*, the Supreme Court said:

[I]t is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose. . . . [W]e believe that the overriding federal law applicable here would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law. . . . Moreover, if federal jurisdiction were limited . . . the hurdles that the victim might face . . . might well prove insuperable to effective relief.⁴⁶

Thus, if the Massachusetts law were as stringent as the district court thought, its application in the instant case would inhibit the purposes of the act. In that event, the First Circuit intimates, the scope of federal common law should include federally created rules of decision governing legitimate excuses from making demand upon shareholders as a condition precedent to bringing a derivative action under the Investment Company Act.

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Estate Taxation—Nature of Insurance Proceeds Includible in Decedent's Gross Estate.—*In re Noel*.¹—This action was brought to review a finding made by the Commissioner that proceeds paid under a flight insurance policy

⁴⁰ *Textile Workers v. Lincoln Mills*, supra note 38.

⁴¹ Labor Management Relations Act of 1947, 61 Stat. 156, 29 U.S.C. § 185 (1958).

⁴² *Textile Workers v. Lincoln Mills*, supra note 38, at 457.

⁴³ *Rogers v. American Can Co.*, supra note 22; *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir. 1961); *Fischbach & Moore, Inc. v. International Union of Operating Eng'rs*, 198 F. Supp. 911 (S.D. Cal. 1961). See Notes, cited supra note 37.

⁴⁴ 377 U.S. 426 (1964).

⁴⁵ 48 Stat. 881 (1934), 15 U.S.C. § 78c (1958).

⁴⁶ Supra note 44, at 433-35.

¹ 332 F.2d 950 (3d Cir. 1964).