

Investment Company Act—Underwriters' Contracts—Annual Approval of Shareholders.—*Saminsky v. Abbott*.¹—Keystone Custodian Funds, Inc. (Keystone), is the corporate trustee of Keystone Custodian Funds (Funds). The Funds, ten common law trusts, are registered under the Investment Company Act of 1940.² Keystone Company of Boston (Keystone-Boston) is the principal underwriter³ of the Funds' shares.

In a derivative suit, plaintiffs, shareholders in the Funds, alleged Keystone had exacted excessive management and expense fees, and that the underwriting contract of the Funds with Keystone-Boston was void for failure to submit the contract to annual shareholder approval. The defendants, the investment company, its directors, and wholly owned underwriter, on a motion for summary judgment, contended that the plaintiffs were estopped from alleging excessive fees because they agreed to them when they purchased shares in the Funds, and that the underwriters' contract was not void because it had been rewritten within two year periods, thereby rendering Section 15 (b)(1) of the Investment Company Act⁴ inapplicable. Defendants' motion for summary judgment as to excessive management and expense fees, and the validity of the underwriters' contract was denied.⁵ HELD: 1. Equitable review of Keystone's management and expense fees was warranted where the fees had reached such exorbitance as to amount to gifts of corporate assets;⁶ 2. The underwriters' contract was void because the contract continued in effect without the required annual shareholder approval of section 15(b)(1). Rewriting the contract within two years by changing the amounts of underwriters' compensation was not sufficient to render the act inapplicable. The act intended to give the shareholders control over the practices of the principal underwriter; merely rewriting the compensation agreement would subvert congressional intent.

Shareholders in investment companies have recently instigated numerous federal and state court actions to protect their interests.⁷ In *Brown v. Bullock*,⁸ the court was satisfied that the Investment Company Act was an indication of congressional intent to create a body of federal law which would protect shareholders in investment companies. The shareholders' complaint was there held to state a federal cause of action, if the director gave only

¹ Sept. 18, 1961, Del. Ch. Ct.

² 54 Stat. 789 (1940), as amended, 15 U.S.C. § 80a-1-52 (1958).

³ "Principal underwriter" is the wholesale distributor of the Funds' shares. Lobell, *The Mutual Fund: A Structural Analysis*, 47 Va. L. Rev. 181, 182 n. 5 (1961): "The principal underwriter who operates under a contract with the fund, bears the entire cost of literature, statistical presentations and other sales aids provided to investment retailers." The principal underwriters' compensation is derived from the sales load. "Sales charges of 8% to 8½% are common. Six % or more may be paid to the retail distributor or principal underwriter."

⁴ Investment Company Act 1940, § 15(b)(1), 54 Stat. 812 (1940), as amended, 15 U.S.C. § 80a-15(b)(1) (1958).

⁵ Defendants' motion for summary judgment, over plaintiffs' contention that Keystone was acting as investment advisor to the Funds in violation of the Investment Company Act, was granted.

⁶ *Rogers v. Hill*, 289 U.S. 528, 591 (1933).

⁷ There are about sixty derivative suits pending in federal and state courts as of October, 1961.

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

token annual approval of the underwriters' and advisors' contract, and if the management fees were excessive as alleged.⁹ Under section 44,¹⁰ state courts have concurrent jurisdiction of violations of the act. The Delaware Chancery Court is here developing a body of law which will protect shareholders in a state forum.

Equitable intervention may be warranted as the plaintiffs allege, but proof of these allegations is not without difficulty. Plaintiff shareholders in *Meiselman v. Eberstadt*¹¹ failed to adduce proof other than the rates of compensation to directors and officers who were shareholders in the advisory company. The plaintiffs claimed that the compensation was excessive. The court assumed that plaintiffs were not alleging the advisory fees to be excessive and dismissed the action, concluding it could not hold the compensation excessive merely because the defendants had received amounts somewhat in excess of the averages received in the industry.

Shareholders have been successful in recovering management fees when they could point to a violation of the Investment Company Act.¹² The court in *Meiselman* had before it compensation payments without an allegation of a violation of the act. With only industrial averages for comparison, the court failed to find excessiveness. In the instant case, the same court is asked again to find fees excessive, not based on a violation of the act, but rather on a violation of the equity doctrine of *Rogers v. Hill*. Plaintiffs have sought discovery proceedings.¹³ This may produce evidence on the excessive fee issue which an equity court should require, and thus save the plaintiffs from the result of *Meiselman*. A review of fees charged by an investment company cannot be carried out in a vacuum. Keystone fees alone lead to no conclusion.¹⁴ A court may be best aided in its review if the fees of comparable investment companies are used as standards, rather than an average of fees charged in an industry. This would have the ad-

⁹ Supra note 8, at 237.

¹⁰ Investment Company Act § 44, 54 Stat. 844 (1940), as amended, 15 U.S.C. § 80a-43 (1958): "The district courts of the United States . . . shall have jurisdiction of violations of this title . . . concurrently with state and territorial courts of all suits in equity and actions at law brought to enforce any liability or duty created by . . . this title."

¹¹ 170 A.2d 720 (Del. Ch. Ct. 1961).

¹² See *Lutz v. Boas*, 171 A.2d 381 (Del. Ch. Ct. 1961). A cause of action for illegal management fees was successful when plaintiffs could show that the fees were paid under an illegal, void advisors' contract.

¹³ Letter from William E. Haudek, counsel for plaintiff, to the B. C. Ind. & Com. L. Rev., Nov. 20, 1961: ". . . By order of October 13, 1961, the Chancellor granted . . . plaintiffs leave to submit additional opposing papers, and if plaintiffs are so advised . . . to apply for permission to conduct discovery proceedings. . . . We, as plaintiffs, are in the process of moving for leave to take discovery proceedings."

¹⁴ Keystone is compensated according to a rate set forth in the trust agreements: Section 3. A recurring charge . . . at the rate of $\frac{1}{4}$ of 1% per annum of the market value of the Fund. This deduction is to be made in lieu of all expenses of operation of the Fund except the management fee Section 4. A management fee shall be computed and deducted from the principal of the Fund at the rate of $\frac{1}{2}$ of 1% per annum of the market value of the Fund.

The management fee . . . shall be reduced to $\frac{3}{8}$ of 1% per annum on that portion of the combined total market value of all Keystone Custodian Funds in excess of \$150,000,000.

vantage of comparing the size of the fund, the composition of the portfolio, the investment objective, the fund performance, and the number of personnel employed. These factors determine the services rendered a fund by its advisors.¹⁵ The fees should be related to the services rendered. A court presented with this evidence would have a sound basis for a determination of excessiveness.

The court, in holding the underwriters' contract void for lack of shareholder approval, looked at the wording of section 15(b)(1),

[The underwriter contract] shall *continue in effect* for a period more than two years from the date of its execution only so long as such *continuance* is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company. (Emphasis added.)

and interpreted the "continue in effect" phrase to relate to the continuing relationship of the underwriters to the Funds, rather than relating to minor contract changes. Defendants contended that the contract was rewritten and changed within two years, thereby conforming with the requirements of the act and not requiring shareholder approval. The court dismissed these contentions with the conclusion that the compensation charges were insignificant, and, since the Funds had no board of directors, the contract required shareholder approval. The court expressed no opinion as to the effect of substantial compensative changes. If substantial changes were held to be required, this would still leave Keystone in a dilemma as to what is substantial.

The court's reasoning was that the relationship between a fund and its principal underwriter may be detrimental to the shareholders¹⁶ because of the practices of the underwriter.¹⁷ This relationship, the court finds by a review of legislative history, is the object of congressional control. A logical extension of their reasoning would lead to the conclusion that no change in the contract could alter the relationship between Keystone and Keystone-Boston. The terms of a contract would not alter the relationship of a corporation with its wholly owned subsidiary.

Shareholder approval would legally give the control of the relationship to the investor. Obtaining annual shareholder approval should present no obstacle to the management in control of the proxy machinery.¹⁸ The

¹⁵ Lobell, *The Mutual Fund: A Structural Analysis*, 47 Va. L. Rev. 181, 182 n. 4, 192 (1961).

¹⁶ See Hearing on S. 3580 Before a Senate Subcommittee on Banking and Currency, 76th Cong., 3d Sess., pt. 1, at 135-45 (1940).

¹⁷ Lobell, *The Mutual Fund: A Structural Analysis*, 47 Va. L. Rev. 181, 208 (1961): "As a whole, the pattern reflects a concern with the fact that any increase in the size of the funds' assets, whether it comes about by sales of shares or by increasing the value of outstanding shares through good investment performance, results in an increase of fee income computed as a percentage of assets."

¹⁸ Ballantine, *Corporations* 180, 412 (2d ed. 1946): "In practice, therefore, proxy voting has operated to enable the management in office to perpetuate itself and control the corporation." Berle and Means, *The Modern Corporation and Private Property* 245 (1933): "Legally the proxy is an agent for the shareholder. Factually, he is a dummy for the management, and is expected to do as he is told." Lattin, *Corporations* 306

comparative ease with which management obtains approval of its proposals should afford a practical means to "continue in effect" this relationship while still complying with the court's interpretation of the statute.

GEORGE T. LENEHAN

Labor Law—Federal Pre-Emption Doctrine—Criminal Trespass.—

People v. Goduto.¹—The defendants, non-employee union organizers, entered upon a parking lot, leased by Sears, Roebuck and Company adjacent to one of their Chicago stores, for the purpose of distributing union leaflets and questionnaires to the store's employees. The operating superintendent asked them to leave several times, but each time they refused. The superintendent then called the police, who arrested the defendants and charged them with a violation of Illinois' criminal trespass statute.² After being convicted in the Chicago Municipal Court, they appealed on the ground, *inter alia*, that Illinois had no jurisdiction because of federal pre-emption of labor disputes. The Illinois Supreme Court affirmed. HELD: "[T]he maintenance of domestic peace and the absence of any preventive relief for the protection of the employer's property rights is of sufficient importance to give [the state] . . . jurisdiction to enforce the criminal trespass statute . . ."³ And although it is arguable that the defendants' conduct was protected by Section 7 of the National Labor Relations Act,⁴ and notwithstanding the fact that a state has no jurisdiction to determine the validity of this defense, nevertheless, because of the defendants' failure to invoke the jurisdiction of the National Labor Relations Board, the state could assume jurisdiction of the crime charged.⁵

The expansion of the federal government into areas once the private domain of the states has been a continuing cause of jurisdictional conflict. A frequent battleground is labor-management relations. Following the enactment of the Wagner Act in 1935,⁶ a series of cases in the United

(1959): "While it (proxy voting) is a useful device to get things done, it is also a device which favors management in its operation, more than the corporation shareholder."

¹ 21 Ill. 2d 605, 174 N.E.2d 385 (1961), cert. denied, 30 U.S.L. Week 3179 (U.S. Dec. 5, 1961).

² Whoever . . . is unlawfully upon the enclosed or unenclosed land of another and is notified to depart therefrom by the owner, or occupant, or by his agent or servant, and neglects or refuses so to do, . . . shall be guilty of a misdemeanor. . . .

Ill. Rev. Stat. ch. 38, § 565 (1957).

³ 174 N.E.2d at 388.

⁴ 61 Stat. 140 (1947), 29 U.S.C. § 157 (1958).

⁵ Contra, *Freeman v. Local 1207, Retail Clerks*, 363 P.2d 803 (Wash. 1961); *State v. Williams*, 37 CCH Lab. Cas. ¶ 65,708 (Md. Crim. Ct., Baltimore City, 1959).

The defendants also contended that, under *Marsh v. Alabama*, 326 U.S. 501 (1946), their right to disseminate information was protected by the first and fourteenth amendments to the United States Constitution. The court distinguished the *Marsh* case by limiting it to its facts and held that the defendants' conduct was not constitutionally protected. On this point there is contrary authority. See *People v. Mazo*, 38 CCH Lab. Cas. ¶ 68,835 (Ill. Cir. Ct. 1959); *State v. Williams*, supra.

⁶ 49 Stat. 449 (1935), as amended, 29 U.S.C. § 151 *et seq.* (1958).