Michigan Law Review

Volume 60 | Issue 5

1962

Securities Regulation- Federal Courts-Private Rights of Action Under the Investment Company Act of 1940

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Recommended Citation
Lee D. Powar, *Securities Regulation- Federal Courts-Private Rights of Action Under the Investment Company Act of 1940*, 60 MICH. L. REV. 655 (1962).
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SECURITIES REGULATION—FEDERAL COURTS—PRIVATE RIGHTS OF ACTION UNDER THE INVESTMENT COMPANY ACT OF 1940—Two actions for damages were brought against officers and directors of a mutual investment fund

alleging violations of the Investment Company Act of 1940.[1] These actions, by the fund itself and by a stockholder on behalf of the fund, were consolidated in a federal district court. The court denied defendant's motion to dismiss for want of federal jurisdiction. On an interlocutory appeal by the non-affiliated directors, *held,* reversed. The Investment Company Act of 1940 does not expressly or by implication create a private right of action cognizable in the federal courts against non-affiliated directors. *Brouk v. Managed Funds, Inc.,* 286 F.2d 901 (8th Cir. 1961), *vacated and remanded for dismissal as moot,* 82 Sup. Ct. 878 (1952).[2]

Since the basis for the decision in the principal case is not made clear, it may rest on either or both of two grounds: (1) there is no private right of action cognizable in the federal courts for damages resulting from violations of duties and liabilities created by the act; or (2) there may be such a right of action, but there is none against these particular appellants. The act purports to protect stockholders and investors,[3] such as the plaintiff, against abuses, but affords them no express means of enforcement. The only express enforcement provisions of the act are found in sections 36[4] and 42,[5] which give limited enforcement powers to the Securities and Exchange Commission. However, section 44 grants jurisdiction to federal district courts ". . . of all suits in equity and actions at law brought to enforce any liability or duty created by . . . this title . . . ,"[6] and from

[1] The violations alleged in the complaint were that the directors: (a) operated the fund in their own interest, rather than in the interest of the fund's security holders. § 1 (b) (2), 54 Stat. 789 (1940), 15 U.S.C. § 80a-1 (b) (2) (1958); (b) caused the fund to publish and circulate documents containing untrue statements or omitting material facts, § 34, 54 Stat. 840 (1940), 15 U.S.C. § 80a-33 (1958); (c) caused the fund to deviate from a fundamental investment policy. § 13, 54 Stat. 811 (1940), 15 U.S.C. § 80a-13 (1958); and (d) that certain of the directors acted as investment advisers without a written contract approved by the outstanding voting securities of the fund. § 15 (a), 54 Stat. 812 (1940), 15 U.S.C. § 80a-15 (a) (1958). For a general discussion of the act, see Jaretzki, *The Investment Company Act of 1940,* 26 WASH. U.L.Q. 303 (1941); Motley, Jackson & Barnard, *Federal Regulation of Investment Companies Since 1940,* 63 HARV. L. REV. 1134 (1950); Thomas, *The Investment Company Act of 1940,* 9 GEO. WASH. L. REV. 918 (1941); Tolins, *The Investment Company Act of 1940,* 26 CORNELL L.Q. 77 (1940); Comment, 50 YALE L.J. 440 (1941).

[2] See Eisenberg and Phillips, *Mutual Fund Litigation—New Frontiers for the Investment Company Act,* 62 COLUM. L. REV. 73 (1962); 75 HARV. L. REV. 634 (1962); 13 STAN. L. REV. 964 (1961).

[3] Investment Company Act of 1940, § 1 (b), 54 Stat. 789, 15 U.S.C. § 80a-1 (b) (1958): "It is . . . declared that the policy and purposes of this title . . . are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

[4] Investment Company Act of 1940, § 36, 54 Stat. 841, 15 U.S.C. § 80a-35 (1958), whereby the Securities and Exchange Commission is exclusively empowered to enjoin gross misconduct and abuse of trust.

[5] Investment Company Act of 1940, § 42, 54 Stat. 842, 15 U.S.C. § 80a-41 (1958), which provides for injunctive enforcement by the Securities and Exchange Commission.

[6] Investment Company Act of 1940, § 44, 54 Stat. 844, 15 U.S.C. § 80a-43 (1958). Furthermore, the reporting requirements of section 33 would appear to be consistent

this section the existence of a private right of action may be implied. In *Brown v. Bullock,*[7] involving the same substantive issues as the principal case, the court found an implied private right of action in favor of the mutual fund's stockholders. Although violations other than those involved in the principal case were alleged, the court, in considering the legislative history and the scope and purpose of the act, found that the duties and liabilities set forth could be enforced by means of private damage actions. Such a right of action has been implied in several other recent cases under the Investment Company Act[8] by analogy to earlier cases in other areas of securities regulation under similar statutory provisions.[9]

If the decision in the principal case was based on the first ground, that

with the implication of a private right of action, particularly in the principal case. 54 Stat. 839 (1940), 15 U.S.C. § 80a-32 (1958), provides that: (a) "Every registered investment company which is a party and every affiliated person of such company who is a party defendant to any action or claim by a registered investment company or a security holder thereof in a derivative capacity against an officer, director, . . . for an alleged breach of official duty . . . , shall transmit . . . [certain documents showing the results of such action] . . . to the . . . [Securities and Exchange] Commission."

7 294 F.2d 415 (2d Cir. 1961) *(en banc)*.

8 Schwartz v. Bowman, 156 F. Supp. 361 (S.D.N.Y. 1957), *appeal dismissed sub nom.* Schwartz v. Eaton, 264 F.2d 195 (2d Cir. 1959); Brown v. Eastern States Corp., 181 F.2d 26 (4th Cir. 1950); Taussig v. Wellington Fund, Inc., 187 F. Supp. 179 (D. Del. 1960) (dictum), 74 HARV. L. REV. 1660 (1961); Cogan v. Johnston, 162 F. Supp. 907 (S.D.N.Y. 1958); Breswick & Co. v. United States, 134 F. Supp. 132 (S.D.N.Y. 1955), *rev'd on other grounds,* 353 U.S. 151 (1957). See generally 2 Loss, SECURITIES REGULATION 1043-60 (2d ed. 1961); 3 *id.* 2005.

9 See Deckert v. Independence Shares Corp., 311 U.S. 282 (1940) [Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77 (1958)]. A civil cause of action was implied under the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78 (1958), in the following cases: Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Slavin v. Germantown Fire Ins. Co., 174 F.2d 799 (3d Cir. 1949); Baird v. Franklin, 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944); Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949); Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), 61 HARV. L. REV. 858 (1948), 14 U. CHI. L. REV. 471 (1947). The same result was obtained under the Public Utilities Holding Company Act of 1935, 49 Stat. 803, 15 U.S.C. § 79 (1958), in Goldstein v. Groesbeck, 142 F.2d 422 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944).

The rationale underlying such an implication of a private right of action is the judicially-developed statutory tort doctrine: members of a class for whose protection a statutory duty is created may sue for injuries resulting from its breach; and the common law will supply a remedy if the statute gives none. Texas & Pac. Ry. v. Rigsby, 241 U.S. 33 (1916). To the same effect, see Taussig v. Wellington Fund, Inc., *supra* note 8, at 217; Baird v. Franklin, *supra* at 245; *cf.* Breswick & Co. v. United States, *supra* note 8, at 138.

In the Second Circuit's opinion in *Brown v. Bullock,* the principal case is cited as perhaps distinguishable if it holds only that there is no remedy afforded by the act against non-affiliated directors of registered investment companies in these circumstances; however, the court expresses its doubts as to whether this was, or should have been, the ground of decision, and disagrees with the decision so far as it is not distinguishable. 294 F.2d 415, 422. *But see* Brown v. Bullock, 194 F. Supp. 207, 247 (S.D.N.Y. 1961).

no private right of action can be implied, it would appear that the contrary decision in *Brown* reaches a more favorable result. This is particularly so in light of the declared congressional intent as to the policy and purposes of the act: ". . . to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."[10] Although no express provision imposing civil liability appears in the act, and although there has been no authoritative settlement of the issue by the Supreme Court,[11] it would seem to be conducive to the effective enforcement of the act that private rights of action be implied.[12]

Assuming, however, that the court in the principal case did not base its holding on the first ground, then the alternative ground, that there was no right of action against these particular appellants, appears to be contrary to the terms of the statute. The only parties to appeal from the denial of the dismissal motion were the directors who were not affiliated with the managing company or the investment adviser of the fund. Non-affiliated directors have the same responsibility as ordinary corporate directors; their non-affiliated status is merely a creation of the act,[13] and does not necessarily lessen their obligations.[14] Furthermore, the statutory definition of "director" makes no such distinction as the decision in the principal case might imply.[15] Therefore, there seems to be no basis for the conclusion

[10] Investment Company Act of 1940, § 1 (b), 54 Stat. 789, 15 U.S.C. § 80a-1 (b) (1958).

[11] The Supreme Court was presented with the opportunity in the principal case, but when the parties settled, the case was vacated as moot. 82 Sup. Ct. 878 (1962).

[12] The authority of the Securities and Exchange Commission to seek injunctive relief does not necessarily preclude private actions. Brown v. Bullock, 194 F. Supp. 207, 245 (S.D.N.Y. 1961); Taussig v. Wellington Fund, Inc., 187 F. Supp. 179, 219 (D. Del. 1960). In *Brown v. Bullock* the Commission appeared as amicus curiae, urging federal jurisdiction in private damage actions. 294 F.2d 415, 417 (2d Cir. 1961).

It would appear that any injunctive or other relief that is available through the Commission has not satisfied the complaining parties. Prior to the commencement of the actions in the principal case a stop order was issued by the Commission against Managed Funds, Inc. In re Managed Funds, Inc., SEC Securities Act Release No. 4122, July 30, 1959. Despite the stop order, plaintiff still demanded damages for the alleged violations. Furthermore, numerous actions are now pending in the Southern District of New York and other federal district courts, in which private damage remedies are being asserted. See Brown v. Bullock, 294 F.2d 415, 417 (2d Cir. 1961).

[13] Investment Company Act of 1940, § 10, 54 Stat. 806, 15 U.S.C. § 80a-10 (1958). This provision opens with the statement 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 investment advisers of, affiliated persons of . . . , or officers or employees of, such registered company." This broad declaration is subject to various exceptions according to particular circumstances.

[14] Lutz v. Boas, 171 A.2d 381, 395 (Del. Ch. 1961). See Aldred Inv. Trust v. SEC, 151 F.2d 254, 260-61 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 GEO. WASH. L. REV. 266 (1959).

[15] Investment Company Act of 1940, § 2 (12), 54 Stat. 790, 15 U.S.C. § 80a-2 (12)

that, for the same violations, the act affords a remedy against affiliated directors and yet does not afford a similar remedy against non-affiliated directors.

Irrespective of whether the court's interpretation of the substantive provisions of the act are correct, its disposition of the principal case on a motion attacking jurisdiction can justifiably be criticized. It would appear that the court used an improper test in determining the jurisdictional issue. Section 44 states that the district court has jurisdiction to hear actions at law under the act. The jurisdictional question presented in the principal case was whether the plaintiff's claim properly *invoked* the jurisdiction of the district court. The Supreme Court in *Bell v. Hood*[16] said that a federal court, in determining its jurisdiction, ". . . must look to the way the complaint is drawn to see if it is drawn so as to claim a right to recover under the Constitution and laws of the United States."[17] However, there is no jurisdiction where ". . . the alleged claim . . . clearly appears to be immaterial and made solely for the purpose of obtaining jurisdiction or where such a claim is wholly insubstantial and frivolous."[18] It does not readily appear that the claim in the principal case is so insubstantial or frivolous as to warrant dismissal for lack of jurisdiction, particularly in light of the ambiguous nature of the jurisdictional grant in section 44 of the act,[19] the length of the opinion which the court thought necessary to justify its decision, and the many other cases in which a private right of action has been implied under the act.[20] "[I]f the plaintiff really makes a substantial claim under an act of Congress there is jurisdiction whether the claim ultimately be held good or bad."[21] Hence, a

(1958): "'Director' means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated. . . ."

16 327 U.S. 678 (1946), an action for damages against FBI agents charged with having detained plaintiffs and having searched their premises in violation of the Fourth and Fifth Amendments. The Supreme Court held that a federal district court had jurisdiction of the action.

17 327 U.S. at 681.

18 *Id.* at 682. See Comment, 48 COLUM. L. REV. 1090, 1095 (1948); *cf.* United States v. Williams, 341 U.S. 58, 65-66 (1951); American Rolex Watch Corp. v. Jack Laufer & Jan Voort, Inc., 176 F. Supp. 858, 861 (E.D.N.Y. 1959).

Justice Stone felt that the limits that the majority had set for obtaining jurisdiction were too broad; that where neither the Constitution ". . . nor any act of Congress affords a remedy . . . , the mere assertion by a plaintiff that he is entitled to such a remedy cannot be said to satisfy jurisdictional requirements." Bell v. Hood, 327 U.S. 678, 685 (dissenting opinion).

19 Section 44 gives to district courts jurisdiction of "all actions at law," yet the act contains no express provision creating an action at law. Investment Company Act of 1940, § 44, 54 Stat. 844, 15 U.S.C. § 80a-43 (1958).

20 See cases cited note 7-8 *supra.*

21 The Fair v. Kohler Die Co., 228 U.S. 22, 25 (1913). In Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961), jurisdiction under the act was sustained and the court also determined the merits of the claimed private right of action on the basis of a motion to

determination of the merits of the plaintiffs' right of action and of the liability of the non-affiliated directors should not have been attempted under the guise of a jurisdictional appeal.

The court in the principal case has examined the Investment Company Act in such detailed manner, in determining whether a private right of action was afforded and what liabilities should be imposed, that it is apparent that the court rejected the jurisdictional test set forth in *Bell v. Hood,* and actually considered meritorious issues.[22] If the Supreme Court adheres to the *Bell v. Hood* test, the court of appeals will appear to have erred in denying jurisdiction. Therefore, regardless of which ground was the actual basis for the decision, it would seem that the principal case should be reversed. Private rights of action should be afforded by implication under the Investment Company Act of 1940, and, once it has been decided that plaintiffs seeking damages have the right to sue, the question of the civil liability of non-affiliated directors should be for the court to determine on the merits, and not in deciding the threshold question of jurisdiction.

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dismiss for "failure to state a claim upon which relief can be granted." FED. R. CIV. P. 12 (b) (6). No such motion was made in the principal case.

22 Judge Clark, in a concurring opinion in *Brown v. Bullock, supra* note 21, at 422, stated that jurisdiction had been found by the district court on the allegations of the complaint and that the majority was prematurely considering meritorious issues. The result of a court attempting to decide a jurisdictional matter and finding itself entrenched in meritorious issues could have serious consequences in two areas: (1) Collateral estoppel—the plaintiffs may be foreclosed from reconsidering issues litigated in the federal court, were they to institute a similar action in a state court. RESTATEMENT, JUDGMENTS § 45, comments *c* and *d* (1942). The appeal to the Court of Appeals for the Second Circuit in *Brown v. Bullock* was allowed only on condition that the plaintiffs stay similar proceedings in a state court. 194 F. Supp. 207, 248-50 (S.D.N.Y. 1961). However, such procedures may not always be available. (2) The doctrine of pendent jurisdiction would lose much of its efficacy, as the non-federal claim will fail if meritorious issues are resolved in denying jurisdiction. Hurn v. Oursler, 289 U.S. 238 (1933); see also Comment, 52 YALE L.J. 922 (1943); Note, 34 MINN. L. REV. 559 (1950); Note, 36 VA. L. REV. 545 (1950). However, the intermingling of jurisdictional and meritorious questions on appeal can be obviated under the Federal Rules by making motions to dismiss both for lack of jurisdiction over the subject-matter, FED. R. CIV. P. 12 (b) (1); and for failure to state a claim upon which relief can be granted, FED. R. CIV. P. 12 (b) (6).