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Fiduciary Duty (Rosenfeld v. Black)

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offer. The court noted that the only thing lost by the plaintiff was the "euphoria he doubtlessly experienced during the summer and fall of 1968"[77] in anticipation of the exchange. This did not constitute "actual damages"[78] compensable under 10(b) or rule 10b-5.[79]

FIDUCIARY DUTY

The problem of the fiduciary duty owed by an investment adviser to a mutual fund was presented in the case of *Rosenfeld v. Black*.[80] Here the plaintiff, a stockholder of the Lazard Fund, Inc. (the Fund) brought actions in both the federal and the state courts[81] on April 11 and 12, 1967 seeking an injunction and an accounting, since the complaint alleged that Lazard Freres & Co.[82] (Lazard), after having acted in

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77 439 F.2d at 335.

78 *See* 15 U.S.C. § 78bb (1970).

79 In concluding, the court made a number of noteworthy points. First, they upheld the district court's dismissal of the section 10(b) and rule 10b-5 complaint on the grounds that the plaintiff failed to meet the "in connection with the purchase or sale of any security" requirement. This is noteworthy because the SEC had filed an amicus brief urging the court to utilize this case as a vehicle for overruling the purchaser-seller requirement of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); *accord*, Iroquois Industries, Inc. v. Syracuse China Corp., 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970).

Second, the court expressed some dissatisfaction with the restrictive interpretation which the district court gave to section 14(e), "in connection with any tender offer." While it felt that the issues did not require it to give its interpretation of 14(e) at this time, the court of appeals, by expressing its dissatisfaction, intimated that it would favor a more lenient interpretation.

Finally, the court made it clear that had the plaintiff been a party who purchased securities in reliance on the defendant's alleged misrepresentations, a good cause of action would have arisen in his favor. 439 F.2d at 335.

80 445 F.2d 1337 (2d Cir. 1971).

81 The court was quite clear in its denunciation of the practice of bringing suit in both federal and state courts.

> We unreservedly condemn this practice which for reasons that are well understood, is so frequently utilized in stockholder actions in the Southern District of New York with respect to investment companies and in many other stockholder suits. A litigant is entitled to his day in one court, but not in two — a consideration of special moment in these times of serious delays in trials.

Id. at 1341 n.5. The court did observe that although a federal court was prohibited from enjoining the state proceeding by the ruling of Kline v. Burke Construction Co., 260 U.S. 226 (1922), nevertheless, it was capable of staying its own proceeding. This the court heartily recommended to avoid this "imposition."

82 The factual pattern of this case is rather complicated despite the fact that the final holding seems obvious. The operative facts began to occur in 1958 when the highly reputed investment banking firm of Lazard Freres organized the mutual fund known as The Lazard Fund under the Investment Companies Act of 1940, 15 U.S.C. § 80a (1970). The initial offering of the Fund was 8,500,000 shares at a price of $15 per share to the public. Lazard Freres which had organized the Fund was employed as its investment adviser. It was to render both investment advice as well as the necessary office facilities and personnel including corporate officers. As compensation for these services Lazard was to receive a certain percentage of the average daily net assets of the Fund.

Despite the fact that the Fund was originally organized as a closed-end investment company it, in essence, conformed to the definition given by the Investment Company Act the capacity of investment adviser to the Fund, sold[83] its advisory office for valuable consideration and thereby breached its fiduciary duty to the Fund. The transaction whereby Lazard was to terminate its duties as investment adviser to the Fund was entered into on April 5, 1967 or just a week before the commencement of this action. The new investment adviser was to be Moody's Advisers & Distributors (Moody's A & D) which was a wholly-owned subsidiary of Moody's Investors Service, Inc.[84] which was itself a wholly-owned subsidiary of Dun & Bradstreet, the party which entered the April 5 agreement with Lazard. In return for several undertakings[85] which were summarized in a proxy statement issued by Lazard to shareholders of the Fund, Lazard was to receive 75,000 shares of the common stock of Dun & Bradstreet at a par value of $1 per share. This agreement was understood to become effective only when a prior agreement providing for a merger of the Lazard Fund into a new Moody's Capital Fund which Moody's Investors Service would organize with a capital of $100,000 was approved.[86] Consequently on April 6, 1967, the Fund sent proxies to its shareholders with a notice of a special meeting the principal business at which would be the approval of the first agreement, namely that of the merger of the Lazard Fund with Moody's Capital Fund and the con-

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of 1940, § 80a-5, to open-end investment companies, in that the shares were redeemable at a charge of 1 percent of the net asset value of the shares tendered for redemption.

83 Unfortunately the plan envisioned by Lazard for the Fund did not materialize. It was the plan that the shrinkage rate caused by redemption unaccompanied by sales would be offset by occasional offerings. At the outset, therefore, there had been no continuous public offering. Due to problems in the mutual fund industry the shrinkage was so great that it couldn't be offset by the occasional offering. In several years the number of shares had decreased to 5,304,711 and net assets were down to $85,000,000. Lazard concluded that continuous offering of the Funds shares was needed as well as the institution of several new investment programs as were used in competitive funds. However, the plan of action needed by the Fund was out of the scope of Lazard Freres so Lazard attempted to find a new investment adviser for the fund and gracefully leave the scene. The question at this point was "who?"

84 In 1966, just at the time Lazard was looking for a potential successor, Moody's Investors Service, Inc. which was managing more than $4 billion in investment funds, was thinking of entering the field of mutual funds.

85 The undertakings set forth in the proxy statement were that for a period of 5 years Lazard Freres & Co. would not (a) become associated in a managerial or an advisory capacity with any other investment company subject to the Investment Company Act of 1940; (b) permit the use of the name "Lazard" or any form of it to be used by any other investment company; (c) act as principal distributor for any open-end investment company making a continuous offering of its shares. Positively, Lazard agreed for a period of 5 years to: (a) make available Mr. Hettinger (who was a partner of Lazard and president of the Fund as well as one of the defendants) for the purpose of advising the new investment adviser as to European economic conditions and to act as director of the new Fund; (b) consult for the transitional period, not to exceed one year, with respect to the administrative operations of the new Fund; (c) use best effort to induce certain persons presently rendering services for Lazard to perform similar services for the new Fund; and (d) make available certain research reports and analyses.

86 This capitalization would come from cash and government securities.

sequent adoption of a further advisory contract whereby the new Capital Fund would employ Moody's A & D as investment adviser at substantially the same terms previously provided for Lazard Freres as as investment adviser to the Lazard Fund.[87] At the meeting 4,269,346 shares were voted approving the merger while 38,545 were voted against it. Thereby all the transactions — namely the merger of Lazard Fund into Capital Fund, the advisory contract whereby Moody's A & D became investment adviser to Capital Fund and the agreement whereby for the undertakings enumerated in its proxy statement Lazard was to receive 75,000 shares[88] of Dun & Bradstreet common stock — were consummated. The defendants at that time moved for summary judgment in the federal suits.[89] It was granted[90] and plaintiffs brought this appeal.

The basic tenet of the plaintiff's appeal was that the 75,000 shares of Dun & Bradstreet were conveyed to Lazard not only for the covenants — not to compete and to be of assistance — but rather "in large part for Lazard's assistance in bringing about the merger and the consequent appointment of Moody's A & D as investment adviser, with the profits anticipated therefrom."[91] In granting the defendant's motion for summary judgment the district court judge did not base his holding on the fact that plaintiff failed to prove that the consideration of 75,000 shares of Dun & Bradstreet stock was too excessive[92] to be solely for the covenants of Lazard. Rather it held that

> where (as here) a majority of the stockholders approve a new advisory contract, as they are empowered to do by 15 U.S.C. § 80a-15(a), the management's conduct in arranging such a substitution does not violate the Act, regardless how it is labelled.[93]

The lower court had obviously come to this conclusion due to its understanding of *S.E.C. v. Insurance Securities, Inc.*[94] Relying heavily upon that case, the lower court stated that "the evil toward which the Act is

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[87] Approval of the merger by the stockholders of the Fund would also constitute approval of the new advisory contract between Capital Fund and Moody's A & D.

[88] These 75,000 shares were to be placed in escrow by Lazard to guarantee performance of its covenants, and the rate of release stipulated was 10,000 shares per year for the next four years with the remaining 35,000 released at the end of the fifth year when the covenants end.

[89] The state actions were discontinued without prejudice.

[90] 319 F. Supp. 891 (S.D.N.Y. 1970).

[91] Rosenfeld v. Black, 445 F.2d 1337, 1341-42 (2d Cir. 1971).

[92] It was noted that there was an uncontested allegation that at the time Dun & Bradstreet contracted to transfer 75,000 shares of its common stock at $1 par value that the stock was selling over-the-counter at over $37 per share!

[93] 445 F.2d at 1342, *quoting* Rosenfeld v. Black, 319 F. Supp. 891, 897 (S.D.N.Y. 1970).

[94] 254 F.2d 642 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958).

directed is the transfer of control without consent of the shareholders . . . not the money received by the assignors of service contracts."[95]

In reversing the district court's summary judgment for the defendant, the court of appeals easily distinguished the *Insurance Securities* case from the *Rosenfeld* case.[96] The starting point of the Second Circuit, rather than being an interpretation of the Investment Companies Act of 1940, was equitable principles. The basic principle of equity which led the court to its decision to reverse was also stated in the *Insurance Securities* case itself: "a personal trustee, corporate officer or director, or other person standing in a fiduciary relationship with another, may not sell or transfer such office for personal gain."[97] The reason for this principle was stated by Chief Judge Friendly with characteristic style:

> A fiduciary endeavoring to influence the selection of a successor must do so with an eye single to the best interests of the beneficiaries. Experience has taught that no matter how highminded a particular fiduciary may be, the only way to ensure full compliance with that duty is to eliminate any possibility of personal gain.[98]

Certainly there could be no doubt that Lazard was in a fiduciary relationship with the Fund.[99] Lazard had organized the Fund and the public had relied on its confidence in Lazard in buying shares of the Lazard Fund. Nevertheless, Lazard might well ask why, if it was convinced Moody's A & D was the best possible candidate for the position of investment adviser, it shouldn't also receive personal gain under the morals of the marketplace. The answer to that was given over 30 years ago in the often-quoted words of Judge Cardozo:

> Many forms of conduct permissible in a work-a-day world for those acting at arm's length, are forbidden to those banned by fiduciary ties. . . . Not honesty alone but the punctilio of an honor the most

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[95] For the district court's approach, see Rosenfeld v. Black, 319 F. Supp. 891, 899 (S.D.N.Y. 1970).

[96] To be sure the *Insurance Securities* case was distinguished in that the SEC proceeded against the defendant there under section 36 of the Investment Companies Act which authorized the Commission to bring action for "gross misconduct or gross abuse of trust." 15 U.S.C. § 80a-36 (1970). Said Chief Judge Friendly, "we would not dream of suggesting, much less holding, that Lazard's actions were so culpable." 445 F.2d at 1346.

[97] 254 F.2d at 650. This statement was supported by a wealth of authority: Essen Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962); Kratzer v. Day, 12 F.2d 724 (9th Cir. 1926); Snyder v. Epstein, 290 F. Supp. 652 (E.D. Wis. 1968); *In re* Caplan, 20 App. Div. 2d 301, 246 N.Y.S.2d 913 (1st Dep't), *aff'd*, 14 N.Y.2d 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964); McClure v. Healy, 244 Pa. 427, 91 A. 428 (1914); Porter v. Healy, 244 Pa. 427, 91 A. 428 (1914).

[98] 445 F.2d at 1342.

[99] For a discussion of the application of the rule against personal profit to investment advisers of mutual funds, see Note, *Protecting the Interests of Mutual Fund Investors in Sales of Management-Corporation Control*, 68 YALE L.J. 113, 121-28 (1958).

sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.[100]

However, the defendants argued that these principles of equity had no application due to the statutory provision of the Investment Companies Act of 1940, § 80a-15(a)(4). It was alleged that pursuant to section 15(a) once the advisory contract was assigned by Lazard to Moody's A & D the statute provided for its automatic and necessary termination. The argument reasoned that since there is an automatic termination of the advisory contract in the event of assignment, then there was no advisory office which Lazard could sell or transfer. This, the court said, "proves too much."[101] For if the assignment was prohibited by statute, as defendants contended, then what was Lazard paid for? Certainly not the assignment. Rather the defendant might well have been compensated "primarily for the use of influence in securing stockholder approval of the successor who expects to profit from the post."[102] This contention of the defendant was therefore summarily discarded by the court of appeals.

A more serious issue which defendant raised was whether Congress has established 15 U.S.C. § 80a-15(a), (c), and (d) as the sole protections to an investment company when a turn-over occurs in the advisory office. The court answered this in the negative, stating that section 15 of the Act was promulgated to provide the additional protection of majority shareholder approval of a new adviser and not to render impotent those protections which equity had already given. Section 15, rather than excluding, actually implied by incorporation the protective principles of equity.[103] Certainly, if Congress provided by statute for the majority stockholder approval of any new advisory contracts, it would be defeating its own purpose if at the same time it allowed the retiring adviser to use the proxy machinery to secure appointment of a successor without following "the standards of abnegation of personal gain that equity had long imposed."[104]

The final allegation of the appellant stockholder which the court considered was the contention that the proxy statement "did not fairly

100 Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

101 445 F.2d at 1344.

102 *Id.*

103 The court reasoned that if all that was necessary to satisfy the statute was majority shareholder approval then this approval might vigorously be sought by an outgoing adviser who saw the possibility of personal gain from the appointment of a certain successor.

104 445 F.2d at 1345. There was also an allegation by the defendant based on the recent amendment to the Investment Company Act, 84 Stat. § 1413 (1970). The decision discussed and discarded the defendant's understanding of recent statutory interpretation. For purposes of brevity the author has chosen to omit discussion of this tangential area of the decision.

summarize the agreement between Lazard and Dun & Bradstreet."[105] The first criticism of the proxy statement concerned the statement that 75,000 shares of Dun & Bradstreet stock were being given solely "as consideration for" the enumerated covenants; allegedly at least a part of it was given to Lazard for its assistance in influencing stockholders' decisions to approve the merger and new advisory contract whereby Moody's A & D would be employed as investment adviser. The issue as the court of appeals saw it was not what Lazard's true motive was but rather "what consideration Lazard was furnishing for that stock."[106] Was it merely the covenants recited in the proxy statement, or was some of the consideration given for the influence Lazard could exert on stockholders to bring about the approval of the merger? While not deciding the merits the court did state that a factual issue was presented sufficient to render summary judgment for the defendant inappropriate.

The second criticism of the proxy statement was of the statement that the 75,000 common shares of stock of Dun & Bradstreet had a "par value of $1 per share." The price these shares were selling for over-the-counter on the date of the contract was in excess of 370 percent of the price quoted in the proxy statement. The court felt that the failure of Lazard to indicate the substantial value of the consideration it received from Dun & Bradstreet might have been found to be misleading[107] if summary judgment had not been granted.[108] The Second Circuit entertained a serious doubt that the stockholders of the Fund would have approved the merger and advisory contract so quickly if they had been informed that Dun & Bradstreet was willing to pay in excess of $2,000,000 for their prompt consummation.

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[105] 445 F.2d at 1349. The court noted that if these allegations of the appellant were valid, all the appellees' arguments concerning shareholder approval would fall.

[106] *Id.*

[107] The statutory requirement is:

False or Misleading Statements.

> (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication written or oral containing any statement which at the time and in the light of the circumstances in which it was made . . . *omits to state any material fact necessary in order to make the statement not false or misleading. . . .*

17 C.F.R. § 240. 14a-9 (1970) (emphasis added).

[108] Once again the court stated no opinion as to the merits of the appellant's case.