ORIGINAL

In the

Supreme Court of the United States

HARRY G. BURKS, JR., et al.,

PETITIONER

V.

HOWARD M. LASKER, et ano.

RESPONDENT

No. 77-1724

Washington, D. C.
January 17, 1979

Pages 1 thru 71

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Petitioners

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No. 77-1724

HOWARD M. LASKER, et ano.,

Respondents

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Wednesday, January 17, 1979
Washington, D.C.

The above-entitled matter came on for argument at 11:00 o'clock a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
JOHN PAUL STEVENS, Associate Justice

APPEARANCES:

DANIEL A. POLLACK, ESQ., 61 Broadway, New York, New York 10006 Counsel for Petitioners Burr, Chalker, Haire, Hutchison and Anchor Corporation

RALPH C. FERRARA, ESQ., Securities and Exchange Commission, Washington, D.C. 20549 Counsel for the Securities and Exchange Commission as Amicus Curiae

JOSEPH H. EINSTEIN, ESQ., 469 Fifth Avenue, New York, New York 10017 Counsel for Respondents

C O N T E N T S

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in Burks against Lasker.

Mr. Pollack, you may proceed whenever you are ready.

ORAL ARGUMENT OF DANIEL A. POLLACK, ESQ.

ON BEHALF OF PETITIONERS

MR. POLLACK: Mr. Chief Justice and may it please the Court:

The central issue in this case may be stated as follows:

Does the Investment Company Act of 1940 deprive the disinterested directors of a mutual fund of their power to terminate a stockholders' derivative action which those directors in good faith have concluded is contrary to the best interests of the fund and its shareholders?

The District Court held that the disinterested directors in the exercise of their good faith business judgment have the power to terminate such an action. The Court of Appeals held it as a matter of law that the directors have no such power irrespective of the fact that they acted in good faith.

Certain subsidiary issues are also raised in this case and they will emerge in my later discussion of the Plaintiffs' point in this case.

The facts are set forth chronologically in our main brief, the white-cover brief, at pages 4 through 19 and in the interest of moving promptly to the central legal issue in this case, I will simply summarize the highlights at this point.

In November, 1969 Fundamental Investors, the Mutual Fund involved in this case, purchased $20 million of the commercial paper of Penn Central. The commercial paper of Penn Central was rated prime, the highest rating by NCO, a subsidiary of Dunn and Bradstreet which is the foremost independent rating agency in the United States.

In June, 1970, Penn Central filed for reorganization and defaulted on the notes. Numerous people were caught in the default as well as Fundamental Investors, banks, trust companies, charities, universities, many other sophisticated and able investors.

In November, 1970 the Board of Directors of Fundamental authorized a lawsuit against Goldman, Sachs, the dealer which had sold the paper. That suit proceeded vigorously for several years as part of a multi-district proceeding.

In February, 1973, three years after the purchase, two stockholders holding very minimal shares filed a derivative action against Anchor Corporation, the investment advisor to Fundamental, and against the directors of Fundamental at the time of the purchase; that is to say, the 1969 directors.

That action was stayed by Judge Gerfein pending resolution of the claims of Fundamental Investors against

Goldman, Sachs.

In July, 1974 on the eve of trial of the action between Fundamental and Goldman, Sachs there was a settlement pursuant to which Fundamental was paid $5,250,000 in cash and also the balance of their claim in the notes of Penn Central in reorganization. The Board of Directors --

QUESTION: Has the value of those yet been ascertained?

MR. POLLACK: The exact value is not a matter of record, Your Honor. However, I believe that the current indication is that the additional paper may be worth as much as $3 or $4 million.

The Board of Directors of Fundamental promptly convened and determined that it would review the Lasker action; that is to say, the derivative action and that the five disinterested directors among them who were not defendants in the Lasker action, who had not been directors at the time of the purchase and who were not affiliated in any way with Anchor would, constituting a quorum, determine what posture the Fund should take with respect to that action.

Those five disinterested directors thereupon retained independent special counsel, former Chief Judge of the State of New York, Stanley H. Fuld and they instructed him to prepare a comprehensive memorandum and report on the subject.

Judge Fuld studied the matter for several months and in December issued a report to the disinterested directors in which he concluded that neither Anchor nor any of the fund directors had violated any law or any contractual or other obligations to Fundamental Investors.

The disinterested directors then deliberated the matter among themselves in a series of special meetings. They interrogated people in the Fund. They interrogated people from Anchor. They questioned Judge Fuld. They communicated extensively among themselves. They had no contact with anyone from Anchor.

In early January 1975 those five disinterested directors put the matter to a vote and unanimously determined that the maintenance of this derivative action against the advisor and the directors was contrary to the best interests of the Fund and they determined that they would move to dismiss the suit.

The motion to dismiss was filed. Judge Werker said that the disinterested directors acting for the Board had the power to determine in the good faith exercise of their business judgment that this suit should be terminated.

QUESTION: This action was taken by a quorum, a lawful quorum of the Board, was it not?

MR. POLLACK: Yes it was, Mr. Chief Justice and in that respect, the Plaintiffs at the time of the motion to dismiss before Judge Werker questioned the independence of these disinterested directors and Judge Werker promptly ordered discovery on the subject.

There was extensive discovery spanning several months. Over 1,000 pages of testimony was taken. There were several document productions. The motion was then renewed and Judge Werker found that there was no basis, no factual basis to question the independence of these directors and he granted the motion to dismiss.

Thereafter, the Court of Appeals reversed. They held that as a matter of law, irrespective of whether the directors had acted in good faith, they were deprived by the Investment Company of the power to make such a decision on behalf of the Fund.

In effect, the Court of Appeals, although it did not use those words, said the disinterested directors could not be trusted.

I turn to the legal analysis at this point.

The starting point of the legal analysis is Deleware Corporation Law Section 141(a). The Court will find that reproduced in the Addendum to our main brief, the white-covered brief.

The language of 141(a) says just this:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a Board of Directors.

Fundamental is a Delaware Corporation. It fits squarely within that provision and we believe that the directors of Fundamental as a Delaware Corporation had and have the power to manage the affairs of the corporation.

This Court has long held in a line of cases going back 75 to 100 years that that power includes the power to determine whether or not claims shall be prosecuted on behalf of the corporation.

This Court in the Corbus and United Copper cases, which are the two seminal cases following Hawes, said as follows -- and I quote two sentences from Corbus: "A court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve or to substitute his judgment for theirs."

Now, that states the business judgment rule as it has been enunciated by this Court.

We turn to the second point in the legal analysis.

QUESTION If all of the directors were directors at the time of the alleged erroneous action, negligent or wrongful action on the part of the corporation and the derivative shareholders sued them all, then he could, in fact, do exactly that.

MR. POLLACK: Arguably, he can.

QUESTION: It is done all the time in derivative suits, is it not?

MR. POLLACK: Arguably that is so, Mr. Justice Stewart but that does not deal with a case such as here where there is a quorum that can pass on the matter.

QUESTION: But that language is a little broader than the facts of life, is it not?

MR. POLLACK: I pass on that one, Your Honor.

QUESTION: Well, are you suggesting that what you read from is a federal rule?

MR. POLLACK: No, I am suggesting that the rule of this Court which has been applied through the years and has guided the interpretation of all courts --

QUESTION: Where would this Court get a rule like that?

MR. POLLACK: This Court was faced with the question. It is a Pre-Erie case, agreed but it was faced with the question as to the powers of directors as a matter of general corporate law.

QUESTION: So I would take it you probably do not agreed with the United States' Amicus brief in this case.

MR. POLLACK: With the United States, Your Honor? We agree with some aspects of their . Insofar as they say that the Investment Company Act is the source of power and governance I do not agree.

QUESTION: But you would not think there is room for a federal rule in this case at all.

MR. POLLACK: We can well-understand the argument for the federal rule in this case, Your Honor.

QUESTION: But now how about -- do you agree with the United States or not?

MR. POLLACK: Our first choice and the logical point of departure is that this is a matter of state law and we hold to that position.

QUESTION: That is what I wanted to know. So you do not think that there is any room for a federal rule in this case.

MR. POLLACK: No, that is not so, Mr. Justice White. What I say is that as a principal starting point what I say is that as a principal or starting point we say state law governs.

However, we recognize that under the Investment Company Act this Court could say that the policies of the Act are so important that it will be taken out of the hands of the states for regulatory purposes.

I recognize that that is the thrust of footnote 11 by Your Honor in the Santa Fe opinion and we are content to live with either side of that equation. We think the more orderly way to decide it is as a matter of state law.

However, we are also content to have the matter decided as a matter of federal law within the policies of the Investment Company Act.

QUESTION: I thought your argument, and maybe I am just saying the same thing in another way or maybe I misunderstand your argument, was that this is a matter of Delaware law where this place was, this outfit was incorporated.

MR. POLLACK: Yes.

QUESTION: Until or unless there is something in the Investment Company Act of 1940 or the Investment Advisors Act or somewhere else in federal law that tells us that Delaware law shall not control in this or that respect.

MR. POLLACK:: That is exactly my argument, Mr. Justice Stewart.

QUESTION: And upon your examination of the federal laws you find that there is nothing there to supercede Delaware law.

MR. POLLACK: That is our position, Your Honor. That is precisely our position.

QUESTION: So you disagree with the United States, then.

MR. POLLACK: Well, I think --

QUESTION: I mean, that is your first preference, is --

MR. POLLACK: Our first preference is state law.

QUESTION: You can understand their argument. You just do not agree with it.

MR. POLLACK: Correct but even under their argument --

QUESTION: Yes, I understand that.

QUESTION: You come out the same way.

MR. POLLACK: We come out the same way. The directors do have the power under the Investment Company Act.

QUESTION: Disinterested directors.

MR. POLLACK: The disinterested directors, absolutely, Your Honor.

I turn now to the opinion of the Court of Appeals. The starting point was Delaware law. The Court of Appeals said that under the Investment Company Act the disinterested directors were deprived of their power.

We believe that this is a misconstruction of the Act, the legislative history of the Act and the cases under the Act.

As regards the Act itself first, I point out to the Court that nowhere does it expressly purport to remove this power from the disinterested directors.

Next, I point out -- as the SEC has said in its brief -- that when Congress meant to remove such power it did so expressly. For example, in Section 36(b).

Furthermore, a reading of the act and its structure indicate clearly that Congress placed great trust in these people and did not have the same jaundiced view of the disinterested directors as held by the Court of Appeals here.

Section 10 provides that 40 per cent of all directors of a mutual fund must be disinterested. Section 15 provides that these are the directors, these disinterested directors who must pass upon and approve the very sensitive issue of the contract, the advisory contract between the fund and the advisor.

We do not believe that Congress would have vested that power in the directors had they believed, as the Court of Appeals did, that they were not to be trusted.

QUESTION: The statutory requirement of 40 per cent disinterested directors came into the Act in the 19-what-70 amendment?

MR. POLLACK: I do not have the answer to that immediately, Your Honor. I believe that it preceded it but the disinterested director category came in in the 1970 amendment.

QUESTION: It was formally unaffiliated.

MR. POLLACK: Correct and I believe that the 40 per cent requirement preceded the 1970 amendment so I will check that.

QUESTION: But I mean when did these directors -- these directors were not directors at the time of the purchase of the Penn Central Railroad.

MR. POLLACK: That is correct, Your Honor. None of these five were on the board at that time.

QUESTION: All right.

MR. POLLACK: One came on the board in 1971, one in 1972, two in 1973 and one in 1974.

QUESTION: And there is no question, is there, that they meet at least the statutory definition of being disinterested directors.

MR. POLLACK: No question, Your Honor, that they meet not only the statutory definition --

QUESTION: What about the fact that they were disinterested?

MR. POLLACK: Well, Judge Werker did, in fact, find that they were disinterested.

QUESTION: I know that because your opponent keeps talking about it.

MR. POLLACK: Yes. I have addressed myself to the Act. I pass now to the legislative history. In the 1970 amendments, Congress added a new Section, 2(a) 19. In that section which created the new category of disinterested directors, they sought to remedy the criticisms of the prior category of unaffiliated directors and they filtered the new definition of disinterested directors, which was a far more stringent one to qualify through the Act in Section 10, Section 15, Section 32. We believe, as the Senate report 91-184 shows -- and we have quoted that in our brief -- that Congress believed that in so doing it had created the necessary sinews in these directors to fulfill the functions of passing on matters that involved the advisor.

Finally, the cases under the Act. There are three cases which we believe to be relevant. We recognize that they are in some respects distinguishable; Tannenbaum, Fogel and Kauffman. The logic of them is not distinguishable.

In each of those three cases the Court of Appeals -- in two cases for the Second Circuit and in one case for the First Circuit -- it was clearly indicated that there is a business judgment rule applicable to mutual funds.

We do not believe that the plaintiffs have come up with a single case or that the Court of Appeals came up with a single case which shows in any way that the Investment Company Act deprived the disinterested directors of their business judgment powers.

In that regard, we are pleased, of course, by the position of the government in this case because the SEC in a rare display of support for a defendant, has said as its central thesis -- and supporting our central thesis of power in the disinterested directors here and I quote from their brief -- "Although Congress could have prohibited the disinterested directors from exercising business judgment in the circumstances of this case, it did not do so."

QUESTION: Whose quote is that?

MR. POLLACK: That is from the SEC brief at page 21, Your Honor. So the SEC thus supports the fundamental premise on which our position is based.

Not only that, they go on to recognize that which is the fact and that is that the business judgment rule is itself an important shareholder protection device.

The rule of the Court of Appeals here would wipe that away in the context of mutual funds.

QUESTION: The SEC both does and does not support your theory but from what you have quoted it would seem to follow that it is in the discretion, the unreviewable discretion of the independent disinterested directors, a majority of the quorum, to make decisions on behalf of the corporation.

MR. POLLACK: I believe the --

QUESTION: But then the SEC says -- well, we will hear from them, I know, but in this kind of a case, since it is a mutual company it is incumbent upon the District Court to look at the fundamental fairness and rectitude of the decision.

MR. POLLACK: Mr. Justice Stewart, the SEC has a three-prong test. The directors have to be independent. They have to be informed and the judgment must be reasonable. They acknowledge in their brief, I believe, that the first two prongs of the test are met --

QUESTION: In this case.

MR. POLLACK: In this case.

QUESTION: So then it is incumbent upon the district judge to see if it was a reasonable decision.

MR. POLLACK: Correct and I will address myself to the issue of reasonableness.

QUESTION: It would seem to follow from what you have quoted to us that it is not incumbent at all on anybody if the directors have the power.

MR. POLLACK: I believe that classically under the business judgment rule as it has been formulated in the cases in this Court that is so. We do believe, however, that even if the SEC test were to be adopted we would meet that test.

We believe that as to reasonableness that is perfectly implicit. Judge Werker would not have dismissed this case, we believe, if he believed that the decision was unreasonable. Furthermore, in their --

QUESTION: It seems to me that a judge who was persuaded by your argument, that this is within the unreviewable power of disinterested directors to make the decision would have dismissed the case even if he -- or might well have dismissed the case -- would have, even if he had thought that this decision might have been a very unreasonable decision.

MR. POLLACK: Mr. Justice Stewart, arguably that is so but I would call Your Honor's attention to the Cramer case where they formulate it a little differently from the SEC. They say that the judgment must be made -- exercise of business judgment must be made in good faith.

Implicit in that is that they be independent and informed and that the judgment not be so unreasonable as to fall outside the bounds of sound discretion. In other words they speak, in effect, of a zone of reasonableness or the bounds of sound discretion.

QUESTION: It seems to me the logic of your argument and indeeed the logic of the language of the SEC brief that you quoted to us leads to a conclusion that would exclude any oversight by a federal judge of whether or not the decision was reasonable. However, maybe not.

MR. POLLACK: Judge Werker also did point out in his opinion expressly that he found that this was a reasoned decision. In footnote 16 of their brief the SEC equates a reasoned determination with reasonableness.

I think that before I sit down at this point in time I would like to address briefly the two subsidiary issues raised by the Plaintiffs. They raise the question as to whether a minority of the full board can take this action. We believe that that has no legal force. The question is, is there a quorum?

Section 141 (a) of Delaware law is quite clear on the subject that a quorum, albeit a minority of the board, has the power to transact the business of the corporation. Therefore --

QUESTION: In that sense, would you say it is analagous to the law which permits six members of this Court to sit as a quorum and if six members are here, four, although a minority, less than a majority of the full Court, may make a binding holding of the Court?

MR. POLLACK: I pondered that very analogy, Your Honor, under 28 U.S.C. 1 which I reviewed the other evening. I think there is a distinction and I think perhaps Mr. Justice Marshall did put his finger on it. The difference is, while it is a minority of the full board that is acting, the quorum itself in the case of the court cannot be a minority because I believe your quorum rule is six out of nine.

QUESTION: Yes but if four of those six decide something, is not that a holding of this Court?

MR. POLLACK: Yes, it is, Your Honor but if the quorum --

QUESTION: It may be regarded as less significant at some time in the future but in the context of that particular decision it makes the law of the case.

MR. POLLACK: Absolutely, no question about that, Your Honor and the concept of quorum is imbedded in corporate law in this country for many, many years.

QUESTION: And what does the Delaware law provide, again?

MR. POLLACK: Delaware law 141(a) I believe provides that a quorum can transact the business of the board and it may be a minority.

QUESTION: Yes, but does it say --

MR. POLLACK: It can be as little as one-third if the By-Laws so permit and in the case of Fundamental the By-Laws had a one-third quorum, so that --

QUESTION: So that the By-Laws actually say, with a minimum of one-third.

MR. POLLACK: Actually, the five here were more than a quorum. Four would have been a quorum. Five actually acted.

The other point that I wish to address before I sit down at this point is their concept that once a derivative action is validly commenced under Rule 23.1 it can never be terminated and in fact what they say is, if you put the key in the lock and you once get the door open, you throw away the key.

Obviously, that makes no sense at all because the directors are the ones charged with the oversight of the business of the corporation and they must have continuing power to review the matters of the corporation and determine on a continuing basis what is in the best interest of the corporation.

We believe that the demand requirement is a procedural requirement which speaks only as of the time of the institution of the suit. It does not and cannot forevermore strip the directors of their power to act for the corporation and vest control of the corporate destiny in a single stockholder.

Thank you, Mr. Chief Justice.

MR. CHIEF JUSTICE BURGER: Mr. Ferrara.

ORAL ARGUMENT OF MR. RALPH C. FERRARA, ESQ.,

ON BEHALF OF S.E.C. as amicus curiae

MR. FERRARA: Mr. Chief Justice and may it please the Court:

The Securities and Exchange Commission believes that an understanding of the relationships between state and federal law as they impact upon the governance of investment companies is critical to a resolution of the issues presented in this case.

First, we agree with the Petitioners that corporate directors and not federal judges should be given the fullest opportunity under state law under the Investment Company Act of 1940 to manage the business affairs of investment companies.

On the other hand, we agree with the Respondents and the Court of Appeals that the Investment Company Act of 1940 superimposes upon basic state law provisions a pervasive array of federal controls, controls which we believe create federal standards to assure the operation of the act will not be frustrated by the possible laxity of the law of an individual state.

Now, the proper reconciliation of both the state and federal interests we believe would neither prohibit as a matter of federal law the disinterested directors of an investment company from terminating even nonfrivolous derivative litigation nor, however, would that law or would that reconciliation embrace the most recent state court formulation of the Delaware business judgment rule as the sole standard by which to judge directorial action.

Rather, we believe that the state and the federal interests can be balanced by according full discretion to the directors' judgments so long as they are independent, they are fully informed and they act reasonably.

QUESTION: Well, Mr. Ferrara, do you find this federal limitation and requirement in the fiduciary obligations imposed by the 1940 Act and in the general purpose of Congress? Is that correct?

MR. FERRARA: That goes to the heart of our authority, Mr. Justice Stewart.

QUESTION: It has to be found somewhere.

MR. FERRARA: It does, indeed. And I think --

QUESTION: Now tell me, where do I find it?

MR. FERRARA: I think that Section 36(a) of the Investment Company Act fiduciary standards, the provision of the Act that imposes upon disinterested investors of an investment company the responsibility to not breach fiduciary duties is the heart of our argument but around that argument is a regulatory statute, a federal regulatory statute which superimposes an array of controls upon the composition of the board of directors, how directors are selected, the manner in which --

QUESTION: There is no claim that any of those provisons were violated in this case, is there?

MR. FERRARA: No, we do not but we do say that surrounding Section 36(a) there are those other controls.

QUESTION: The numbers. You find it in the numbers.

MR. FERRARA: That is correct, sir.

QUESTION: But there is no problem about any of those things in this case, on the basis of the majority. There is full compliance, whether they are applicable or not.

MR. FERRARA: Well, recall, Mr. Chief Justice, that Section 36(a) of the Act, the General Fiduciary Standard, proscribes breaches of fiduciary duty involving personal misconduct and the House and the Senate, at the time they enacted those provisions in 1970 said --

QUESTION: Well, you would not need Congress to tell a state court that, would you?

MR. FERRARA: Well, you might. Unfortunately, the District Court judge in this case found that all state law would require is that the directors be independent and act in good faith.

The Congress was required in the Investment Company Act of 1940 that there be an additional ingredient; that is, that the decisions be reasonable. That additional ingredient finds its heart in Section 36(a),as I said a moment ago in the House and Senate reports that accompany the enactment of that section, where they provided, in these words, that "36(a) proscribed nonfeasance of duty and abdication of responsibility."

Those words go far beyond, we think, the typical fraud statute that is found in one of the federal securities laws. They expand upon notions of fiduciary duty as found even in Delaware law.

Now, does that mean that Delaware law has to be displaced by a federal standard? No. But does it mean that when the Delaware statute or an Idaho statute or an Ohio statute says that directors shall be accorded the business judgment rule and the courts of that state say that the business judgment rule only needs to be tested against an independence and good faith standard that if it is an investment company, an additional standard needs to be employed?

We think the Investment Company Act says that. We think the courts say that, that have interpreted the Investment Company Act.

QUESTION: Mr. Ferrara, there are so many statutory provisions I may get them mixed up but --

MR. FERRARA: I do, too.

QUESTION: Section 36(a) is Section 80(a)-35 of -- that is the same one which authorizes the commission to bring certain kinds of litigation.

MR. FERRARA: It does, indeed.

QUESTION: Does it have anything to do with private litigation?

MR. FERRARA: The issue that you are implicitly raising, Mr. Justice Stevens, is whether there is an implied right of action under Section 36(a) of the Investment Company Act. That is an issue that is specifically not in this case.

However, the courts have found that notwithstanding the language of the statutes that the commission may bring an action to enjoin that there is a private right of action under Section 36.

As a matter of fact, the courts have rather consistently held that position although, again, that is not an issue in this case. It has not been raised by --

QUESTION: You are really going one step beyond that. What you are in effect saying is that not only does 36(a) authorize the SEC to bring an action, it also implicitly authorizes a private action and beyond that it places certain restrictions on the power of independent directors to settle such an action after it has been brought.

MR. FERRARA: Mr. Justice Stevens, I am sure that the day is going to come when myself or one of my successors is going to be here arguing the case that 36(a) creates an implied right of action for private litigants under the Investment Company Act. We do not have to take that position now. Nor does this case involve the Commission's power to bring an injunctive action under Section 36(a).

All it does say is that whoever has the right to bring the action, the private party or the Commission, the standard upon which the action has to be based is the breach of fiduciary duty. This recalls -- this is not --

QUESTION: Granting all that, where in here does it say anything about who can settle such an action? Place any limitations on the power to settle such an action?

I am assuming for purposes of our decision, just the same assumption you make. We will assume there is a private remedy. We are not talking about whether there is a private remedy. We are talking about who can cut off the private remedy and what in the statute says anything about that?

MR. FERRARA: Nothing in the statute, you are quite correct.

QUESTION: This is not quite a private remedy. This is a derivative lawsuit --

MR. FERRARA: It is indeed.

QUESTION: -- on behalf of a corporation --

MR. FERRARA: It is indeed and the posture --

QUESTION: -- under no authority of the Investment Company Act of 1940 but under quite different authorization.

MR. FERRARA: Well, the allegations contained a violation of the Investment Company Act of 1940 and the Advisors Act, two federal claims. Now, you are quite correct procedurally. This case involves the disposition of a derivative action in the context where a federal district court judge was being asked in a contested claim and an involuntary dismissal whether the action should be dismissed and the federal district court judge was faced with the situation of whether to dismiss the action over the objections of the Plaintiffs who had instituted the action.

In that context, the federal district court judge was forced to sort out the basis upon which he dismissed the action and he did that by, we think, reference to both state law standards, the Delaware law -- independence and good faith -- and by reference to the federal standards.

I quite frankly think that if Tannenbaum against Zeller, the case that we cite as authority for the three-prong test that we urge in our brief, had been decided at the time this district court judge had before him the dismissal of this action, his conduct in the action may have been a little different and his decision may have read slightly differently. I am not sure that the result would have changed but that is not our job.

QUESTION: You say he then would have made findings under the unreasonableness itself.

MR. FERRARA: I think he would have. We are not --

QUESTION: Still, to get the thing -- I do not mean to take up too much time but he could have acted just on the basis of state law and now the other side says, well, you can not do that because the federal statute restricts your power, the independent director's power to settle. I would normally look to some provision in the federal statute that describes the powers and duties of independent directors rather than something that gives somebody a cause of action.

MR. FERRARA: But the Investment Company Act of 1940 clearly detailed that -- not only described the duties of independent directors but says that you cannot even have a board of directors unless 40 per cent of them are disinterested and then it says --

QUESTION: Right but there is not anything that says those directors cannot settle a lawsuit. That is what --

MR. FERRARA: No but the question is not whether or not they can settle a lawsuit but whether in the process of settling a lawsuit they breach their fiduciary duties to the shareholders of the fund. A disinterested director or any director of an investment company simply cannot, without reference to any standard -- without reference to any standard, dismiss a lawsuit.

QUESTION: Well, where is the standard in the federal statute?

MR. FERRARA: The standard is in Section 36(a) because of all of the directors --

QUESTION: Can you read it?

MR. FERRARA: Section 36(a) proscribes breaches of fiduciary based upon --

QUESTION: Yes, but does it say what a breach of fiduciary duty is?

MR. FERRARA: The statute does not say what a breach of fiduciary duty is but the Congress in both the House and the Senate Report when they passed that statute said what they thought it meant.

QUESTION: Well, I still do not think you have answered Mr. Justice Stevens yet, where --

MR. FERRARA: I am sorry.

QUESTION: -- he said what specifically in the statute forbids a settlement unless you go through this ritual.

MR. FERRARA: Let me try once again --

QUESTION: -- because you know there is a question of just how specific must the federal law be? And in Cort against Ash the Court said -- and I am sure you must be quite familiar with that statement in Cort against Ash that --

MR. FERRARA: Indeed I am, sir.

QUESTION: -- that except where federal law expressly requires certain responsibilities of directors with respect to the state law will govern internal affairs of corporations.

MR. FERRARA: You have raised two questions. Let me try to respond to your first question which is also Mr. Justice Stevens' question and --

QUESTION: All right, fine, you may respond to Mr. Justice Stevens' question.

MR. FERRARA: First, the Investment Company Act clearly defines the composition of a Board of Directors; 40 per cent must be disinterested.

Now, in all actions taken by those directors, dismissals of lawsuits, purchases of securities, whatever the directorial action calls for, those directors' conduct is guided by Section 36(a). Section 36(a) says that whatever the director is doing, dismissing a lawsuit or otherwise, that director could not breach a fiduciary duty.

The House and the Senate say what a fiduciary duty is and that is, non-feasance of duty or abdication of responsibility. Consequently, in deciding whether the directors lived up to their responsibilities under Section 36(a) in this case, one has to determine whether they abdicated their responsibility or engaged in non-feasance.

Now, returning --

QUESTION: We have always had the fiduciaries vis-a-vis the shareholders.

MR. FERRARA: No, always -- you are quite right, Mr. Justice Stewart. All directors are fiduciaries but here because of Section 36(a) I suppose you would say investment company directors are super fiduciaries, particularly disinterested directors because there is no other federal statute, not the Securities Act, not the Securities Exchange Act, not the Public Utility Holding Company Act of 1934, 1935 -- no other federal statute has an express provision that says that these directors have to have a fiduciary duty.

Recall, this was not Green against Santa Fe -- getting back to the question of yours -- this is not Green against Santa Fe, this is not a Section 10(b)5 that involves fraud, deception or manipulation. This is a Section 36(a) that talks in terms of breach of the fiduciary duty.

Now, turning to the question about Cort against Ash and Green against Santa Fe, clearly, the Court in those cases said that state law is not going to be displaced unless there is a federal statute which expressly calls for that. This case is not at Green against Santa Fe. It does not involve Section 10 (b), what this Court found to be a disclosure-based statute but rather, 36(a) and we are not trying to displace the entirety of state law. All we are suggesting -- I am sorry --

QUESTION: No, but you certainly are putting in quite a gloss on it.

MR. FERRARA: A very modest gloss, I would suggest. Once you have determined that state law requires independence and good faith, we think that asking that a --

QUESTION: I do not know if some federal judge will think it is a very mild gloss if he has to sit down and decide whether judgment is reasonable.

MR. FERRARA: We are not asking that he substitute his judgment for that of the directors.

QUESTION: You are asking him to do something that he would not have to do under state law.

MR. FERRARA: We are asking -- I am sorry --

QUESTION: Mr. Ferrara, since we have emphasized that section so much and what Congress intended, it is certainly not unimportant -- and this is in your brief at page 21 -- the statement from the legislative history that it is not intended by this statute to shift the responsibility for managing an investment company in the best interests of the shareholders from the directors of such companies to the judiciary.

MR. FERRARA: Clearly.

QUESTION: Now, that thins out this gloss a little bit, does it not?

MR. FERRARA: Mr. Chief Justice, it does thin it out a little bit and that is exactly why we cannot be here fully supporting the Court of Appeals. The Court of Appeals, we think, went too far and would have substituted the federal judiciary for the disinterested directors.

We are saying that the federal district court judge should not substitute his own judgment for that of the directors but only in reviewing this action, that he determine whether the directors acted reasonably in the same process that he has to decide whether they were independent and acting with faith.

QUESTION: You are making the district judge a super director. You spoke of super fiduciaries. You are making him a super, super fiduciary.

MR. FERRARA: Mr. Chief Justice, if the impression left by our brief is that we are asking a federal district court judge to become a director of an investment company, then our brief reads incorrectly. We are not asking that.

QUESTION: Well, then, but you must concede that under your formulation a district judge could conclude this is an unreasonable decision by the directors and set it aside.

MR. FERRARA: The district court judge could, consistent with, actually, a line of authority that stretches back to 1917 in this Court's case in United Copper --

QUESTION: Well, let us not --

QUESTION: That is a bootstrap. That is a bootstrap.

MR. FERRARA: The district court -- district court judges all the time and in different kinds of contexts have to determine whether or not conduct is reasonable.

At the time the district court judge is doing that he does not always --

QUESTION: So you are agreeing yes, the district judge can, under your formulation, set it aside as unreasonable.

MR. FERRARA: Absolutely but --

QUESTION: You say he always could.

MR. FERRARA: No, no, I --

QUESTION: You say under your formulation he may set it aside.

MR. FERRARA: I absolutely agree that a district court judge may set aside directorial action as unreasonable but I do not say that he --

QUESTION: Even though a state court would not.

MR. FERRARA: The state court would have never reached the question.

QUESTION: Well, the state --

MR. FERRARA: Because the state court never considered the question. They considered something slightly different.

QUESTION: The state court would find the director's action to be quite consistent and would not set it aside and you suggested under your formulation the federal court could.

MR. FERRARA: No, I say that if the state courts viewed reasonableness as a criteria of its review, then it could set it aside.

The federal judge, in setting aside -- empowering the federal judge to set aside directorial action as unreasonable, though, again I suggest, I submit, I emphasize, does not mean that the judge has to substitute his judgment. All it means is that, as in a dozen other different contexts, that federal district court judges face, he has to pass upon the fundamental reasonableness of the transaction.

QUESTION: Let us take just a moment, we had one this morning.

MR. FERRARA: We certainly did.

QUESTION: And we know that that is quite right. In other contexts judges do but they usually can trace the exercise of their review to some specific source, that is, the Fourth Amendment, the reasonableness of the search. Can you suggest any places where the judge does this without being able to trace it to some specific authority?

MR. FERRARA: A court, I believe in passing upon a judgment notwithstanding the verdict, passing upon a directed verdict, other --

QUESTION: Well, first let us take the first one.

MR. FERRARA: Yes, I believe --

QUESTION: Or a judgment NOV.

MR. FERRARA: That is correct. Does not the judge at that point, Mr. Chief Justice, have to weigh whether or not it would be unreasonable for --

QUESTION: No, he weighs the question of whether or not the evidence supports the verdict.

MR. FERRARA: That is right, in the minds of the reasonable juror. Is not that a standard that is incorporated in that under the case law? It is not in the rule, but under the case law?

QUESTION: That is a weighing of evidence, not a weighing of the reasonableness, I submit to you.

MR. FERRARA: Yes, sir.

MR. CHIEF JUSTICE BURGER: Well, very well, we have explored it fully. Thank you.

QUESTION: Mr. Ferrara, I would like to ask you a couple of questions. Let us assume that we agreed with the position of the commission remanding the case for the application of your three-part test, the third part of which has been the subject of a good deal of discussion.

What do you think the district court would do in the way of determining whether or not the independent directors had exercised a reasonable judgment -- and here I pause to say that the district judge had a very substantial amount of information before him. Do you think he could act on that information, Judge Fuld's report, the discussions of the independent directors with independent experts? Or do you think he would have to have another full-blown trial, evidentiary trial?

MR. FERRARA: It is a very difficult question. Let me try to respond at two levels. First, it is hotly contested in this case whether or not the judge allowed a sufficient amount of discovery to go forward to pass upon the question of the independence and good faith of the directors.

The judge, we think, on remand --

QUESTION: That is a question separate from reasonableness.

MR. FERRARA: I know it is but you asked, I think, two questions.

QUESTION: Yes.

MR. FERRARA: One, what would the district court judge have to do in terms of the record and two, what would he have to do in terms of satisfying the reasonableness standard.

QUESTION: Yes.

MR. FERRARA: In terms of the record, the first determination he would have to make is whether or not there was a sufficient record before him to pass upon the reasonableness of the directors' actions.

I think that there are two views on that. The Respondents would urge -- I am sorry -- the Petitioners would urge that the district court judge too closely circumscribed their ability to seek discovery on the question of the merits of the action. I believe that the district court judge, in looking at the discovery that was permitted, may find that adequate discovery was had but the district court judge in his sound discretion would have to determine that.

I do not see and I think it would be wrong to say that the district court judge would have to conduct thereafter a full trial on the merits. There should still be a proceeding that is within the sound discretion of the district court judge to tailor.

Now, the one -- look, there is nothing magic in the locution reasonableness. We did not go through the opinion as did Respondents --

QUESTION: Let me interrupt you a minute. If you have got to try this case on the merits --

MR. FERRARA: No --

QUESTION: Wait a minute. The question would be, in various summary terms, whether or not the management had exercised the degree of care required of management in purchasing the Penn Central commercial paper. Do you agree with that so far?

MR. FERRARA: I agree that -- that is --

QUESTION: Correct.

MR. FERRARA: Under the state law claim that is correct.

QUESTION: That is right. Well, in other words, whether or not there was a fair chance to win the case --

MR. FERRARA: That is correct.

QUESTION: -- it might have a bearing on the independent director's exercise --

MR. FERRARA: That is right.

QUESTION: -- of reasonable judgment. Is it your suggestion that the district court would have to make a judgment himself as to whether there was a fair chance to win the case?

MR. FERRARA: That is --

QUESTION: If so, would he not have to try almost a full-blown trial?

MR. FERRARA: The if so is no. The second question is no. But let me get to the first. That first question goes to the heart of our concern with the district court's opinion.

The district court judge, while purporting to evaluate good faith and independence -- and as I say, there is no magic to finding the word "reasonable" in the opinion -- but in pruporting to focus on good faith and independence, specifically said that he was not going to concern himself one whit with the merits of the action.

He said he was not even going to let the merits of the action color his decision. Now --

QUESTION: But you think he must look into the merits.

MR. FERRARA: Now, we think he at least has to take a look at the merits. I mean, he at least has to consider whether, in view of what the apparent merits of the action are under any formulation, the Tannenbaum test, the Kauffman test, the Cramer test, the Auerbach test, whatever formulation of our three-prong test you want to use, then you have to pass on reasonableness.

If this district court judge someplace in his opinion had said -- and in addition to looking at whether or not these directors were independent and whether or not they had all this information that Judge Fuld produced for us, we also gave some consideration to the merits of this action as they were expatiated on in Judge Fuld's memo, I think we would have a different case but he specifically in at least two different places said, "I am not going to consider the merits of this action. They are not going to color my judgment." That is his words, Your Honor. "It is not going to color."

QUESTION: That would have been exactly what he should have said had Delaware law exclusively applied. You would agree with that.

MR. FERRARA: Your Honor, it depends on how you view the good faith requirement of Delaware law. I am not even sure under Delaware law that if the district court judge is asked to pass upon the good faith of disinterested directors or independent directors of the 1940 -act company, he disregards the merits completely, that he can meet that good faith standard.

QUESTION: Well, I understood --

MR. FERRARA: But that is not an issue in this case.

QUESTION: Well, it is an issue in this case.

MR. FERRARA: It is an issue --

QUESTION: It is very much an issue in this case.

MR. FERRARA: It is an issue in this case only to the extent that you have to try to --

QUESTION: If Delaware law exclusively applies to this case, then it is very important to know what Delaware law is.

MR. FERRARA: It is and under Delaware law, while I have not researched the Delaware cases, we would submit that within the notion of good faith, under Delaware law, there has to be some consideration given to the merits; not a full trial, not what Mr. Justice Powell is concerned with --

QUESTION: Was there any claim here that these disinterested directors acted in bad faith?

MR. FERRARA: As a matter of fact, the district court judge found they acted in good faith.

QUESTION: Exactly.

MR. FERRARA: But he did that without --

QUESTION: Is not that the test of Delaware law?

MR. FERRARA: The Delawara law tests his good faith but how --

QUESTION: Exactly.

MR. FERRARA: The issue is whether in determining that they acted in good faith you can make that determination completely divorced of the merits of the actions and irrespective of whether he --

QUESTION: He could be very badly mistaken but still be in complete good faith and wholly disinterested.

MR. FERRARA: If they are very badly --

QUESTION: And at the same time make what somebody else would think would be an unreasonable decision.

MR. FERRARA: When you put it that way, though, this is a box that we get in. If, let's say, it is in a box --

QUESTION: Well, you are in a box. I do not know if anybody else is.

MR. FERRARA: I am sorry, you are right, the box that I get into is that when you are dealing with an investment company and the disinterested directors of an investment company, unfortunately you may have to go that one extra step because of 36(a) --

QUESTION: Well, I

MR. FERRARA: It proscribes unreasonable conduct.

QUESTION: That is your claim that the numbers of the 1940 Act put some limitations on what would ordinarily be the provisions of state law. If you are mistaken, then, I submit, it is quite important and not at all irrelevant to know what the state law is.

MR. FERRARA: Absolutely and again, on the penumbra question, I agree, there is a variety of sections which impact upon this but penumbra does not, I think, appropriately categorize -- characterize 36(a) that talks in terms, at least in the House and Senate reports, of unreasonableness.

QUESTION: It is not too clear, is it not, Mr. Ferrara, that if your super fiduciary theory is correct and these directors are found to have acted unreasonably, under 36(a) they would be personally liable in damages.

MR. FERRARA: They might be, yes.

Mr. Justice Stevens, it is a very -- recall there is that famous -- I guess famous in the private Bar and the government Bar -- footnote 11 to this Court's opinion in Green against Santa Fe and that footnote, in distinguishing or explaining what this Court perceived the reach of Rule 10(b)5 in Section 10(b) was, you said, this is a lot different than Section 206 of the Investment Advisors Act.

You said there -- and these are the words of this Court, you said there federal fiduciary principles were being applied and Section 206 of the Advisors Act, although the companion statute of the Investment Company Act says nothing about fiduciary duties.

I mean, this is hard-core federal fiduciary principles in Section 36(a).

Thank you very much. Sorry for the --

MR. CHIEF JUSTICE BURGER: All right.

Mr. Einstein.

ORAL ARGUMENT OF JOSEPH H. EINSTEIN, ESQ.

MR. EINSTEIN: I want to relieve your anxiety. We will not charge Mr. Ferrara's overtime to you because we were largely responsible for it.

MR. EINSTEIN: Thank you, Your Honor. I was not the least bit anxious.

Mr. Chief Justice. May it please the Court:

Late in 1969, the Mutual Fund here purchased $20 million worth of Penn Central notes. The record clearly establishes that it entered into this purchase at the suggestion of its advisor, Anchor Corporation, in a situation where there was absolutely no investigation whatsoever conducted as to the propriety of the $20 million investment.

This occurred even though Anchor was at the time receiving some $4 million per year for allegedly managing the portfolio of this investment fund.

Now, in buying the notes, not only did Anchor fail to conduct any investigation but it failed over the next six or seven months to be aware of the increasing storm signs and warnings as to the dismal, failing condition of Penn Central and failed to even execute a buy-out or a sell-out of the notes when it might have.

Moreover, there was an internal guideline in the fund which said that the fund should not purchase commercial paper of this nature unless it had a commitment that it could sell it, a so-called "buy-back" commitment.

Now, in their reply brief, my adversary has said that we have misleadingly asserted that this buy-back provision was violated because Anchor believed that it had such an understanding yet Judge Fuld disagreed.

He stated, at page 113 of the Appendix, accordingly, "It appears that there was not and that Anchor did not believe there was any legal, binding agreement by Goldman, Sachs to repurchase Penn Central paper.

Therefore, I think the case comes before Your Honors in a situation where you have in my judgment and the judgment of the Court of Appeals a rather strong showing of breach of fiduciary duty and gross abuse of trust in violation of the 1940 Act by Anchor and by the directors at the time of the Mutual Fund. Now --

QUESTION: Are you suggesting that this was negligence that was so gross as to rise to the level of a breach of trust?

MR. EINSTEIN: Yes, I do, Your Honor. I think --

QUESTION: In other words, it was utterly stupid to do what they did or fail to do --

MR. EINSTEIN: I think it goes even beyond stupidity.

QUESTION: And that was the basis of your derivative shareholders' action.

MR. EINSTEIN: That is absolutely right, Your Honor.

QUESTION: Which really only tangentially bears on the issue here.

MR. EINSTEIN: Well, as I will come to in a moment, I do think that the merits of the action do very much bear on the issue here.

Now, as the Court is aware, there was this lawsuit brought by the Fund against Goldman, Sachs alleging fraud in this representation at the time of the purchase.

Now, that suit was settled for slightly over 25 per cent of the loss and I must advise the Court that one of the reasons that motivated the Fund to settle was because it had a sophisticated advisor and it was worried that if it pressed the litigation, the effect of its having an allegedly sophisticated advisor might militate against recovery.

Now, even if you take the $5 million that has been recovered and you ascribe whatever value you want to to these pieces of paper that have been issued to the Fund as additional settlement value, there is still a shortfall here of $10, $12, $15 million which we believe should be recouped from Anchor and from the defendant directors.

Now, after the action against Goldman, Sachs was settled the motion which leads us to this Court today was interposed by the Defendant.

Now, it is significant to note that shortly after the Penn Central collapsed, the Board of Directors of the Fund determined to sue Goldman, Sachs. They also determined to hold in abeyance any other action against anyone else.

Now, over the years, between that time and 1970 and 1974 when the dismissal motion was interposed, the Fund's Board of Directors did change and you composed a five-member minority of the Board who were independent and unaffiliated with Anchor. It was these minority directors who ultimately determined to seek dismissal of this action.

Now, initially, when the motion was made in the district court, the district court permitted discovery and it appears on page 20 of the Appendix on a very, very limited plane.

He permitted discovery to pursue the relationship of the minority directors and the qualifications committee to determine whehter the minority directors were disinterested or independent. That was the sole scope of the discovery allowed in this action.

Now, it is significant to note that the discovery permitted did not include any discovery on the merits, did not include any discovery on the nature and content of the disclosures made to Judge Fuld and I think that is a significant area because the disinterested minority directors could only act based upon information filtered to them through Judge Fuld through their special counsel. That, the disclosures being made to special counsel were the disclosures of the Defendant Directors and Anchor Corporation, made not under oath but in informal discussions.

Now, I think it was important for the district judge to have had -- and he could not have had in this case -- an indication of whether the full mix of available information was supplied to Judge Fuld and through him to the minority independent directors. Now, all --

QUESTION: Now, why would that be important? I just want to understand you. To what issue would that have been relevant?

MR. EINSTEIN: That would go to the reasonableness, Mr. Justice Stevens, of the dismissal of the action and I submit to you, as a principal thesis here and one that has been overlooked and not mentioned up till now, that this case is governed very much by Rule 23.1 promulgated by this Court.

QUESTION: But Mr. Einstein, if I understand at least the SEC's position, they do not challenge the fully-informed character of the independent directors' decision.

MR. EINSTEIN: I do not see how anybody on this record can assert, with all deference to the SEC, that the directors were fully informed. There is nothing in this record which will disclose what information was given to the directors and what information may have been withheld.

QUESTION: But is it not quite clear that the restriction on discovery of which you complain would be more pertinent to the question of full information than to the question of reasonableness? Would it not be? I think perhaps it is relevant to both.

MR. EINSTEIN: I think it is relevant to both and I think the question of merit also is relevant because a decision to dismiss a case of very weak merit --

QUESTION: I understand.

MR. EINSTEIN: -- may be supportable on very slim business judgment rules whereas if the case has strong merit you would need more to support a dismissal.

QUESTION: It would seem to me -- maybe I missed something but if we were persuaded, and I do not know whether we should be or not, that the SEC is correct in saying that the independent directors were fully informed, then we should not test reasonableness by the failure to get more information.

MR. EINSTEIN: If they were fully-informed, they were fully-informed. I just submit to Your Honor that if this record clearly demonstrates -- is silent on that issue then, indeed, we believe that they were not fully-informed.

QUESTION: Thank you.

QUESTION: Did the district judge make a finding on that point?

MR. EINSTEIN: I do not believe he did, Your Honor.

The district judge opinion really proceeds strictly on the authority of the minority quorum to bring about this dismissal.

QUESTION: He did find they were independent.

MR. EINSTEIN: Yes, Your Honor, he did and that finding was, in effect, overruled by the Second Circuit both, I believe, on the facts and on the law.

QUESTION: He also found that they acted in good faith.

MR. EINSTEIN: Yes, Your Honor.

QUESTION: As I read the Second Circuit, it did not overrule a finding of fact, it merely questioned whether anyone could be an independent director at any time under any circumstances.

QUESTION: Or whether or not these directors had any power to do what they did.

MR. EINSTEIN: The Second Circuit, Your Honor, the opinion I find somewhat ambivalent on this issue because if you look at pages 46 and 47 of the Appendix where the opinion appears, the Second Circuit clearly discusses the fact that these directors served not only as directors on this fund's board but on a number of other boards with funds managed by Anchor and received $11,000 to $13,000 per annum compensation.

MR. CHIEF JUSTICE BURGER: We will resume there at 1:00 o'clock.

[Whereupon, at 12:00 o'clock noon, a recess was taken for luncheon until 1:00 o'clock p.m.]

AFTERNOON SESSION 1:00 p.m.

MR. CHIEF JUSTICE BURGER: Mr. Einstein, you may resume.

MR. EINSTEIN: Mr. Chief Justice. May it please the Court:

Just before the lunch break I was discussing a decision of the Second Circuit and I believe that I had indicated that the Second Circuit's opinion is not based entirely upon its view of the situation as a matter of law but considered the factual context in which the minority found itself, particularly the fact that the minority had been selected by the Defendant Directors through a very complex and carefully-controlled screening process.

Every minority director who voted in favor of dismissal of this case was screened by a directors' qualifications committee dominated by defendants and was nominated for election to the board by the Defendant Directors. I could posit a --

QUESTION: Does that taint them?

MR. EINSTEIN: I think that given those facts and given the nature of mutual funds and the everyday facts of life which the Court of Appeals did find as to the nature of mutual funds, it does taint them.

I could posit, Your Honor, a situation where they might not be tainted, where the nomination process was far more independent.

QUESTION: I take it you suggest the burden is more or less on the other leg, that the existing directors have to or the alleged disinterested directors have to prove that they are not tainted.

MR. EINSTEIN: I would think that they would have a burden of coming forward and proving their independence or lack of taint. What I am suggesting basically --

QUESTION: I suggest to you that makes it not very appealing to be elected to a board of directors.

MR. EINSTEIN: I am not suggesting that they would be tainted in other matters but when they seek to exculpate the majority of the board in a derivative action from charges of wrongdoing, I think there is a burden of proof that must be undertaken.

Now, much has been said, Your Honor, about applying state law standards, Delaware law. It seems to me that the standards that are applicable here are the standards presecribed by Rule 23.1 of the Rules of Federal Procedure.

Now, it so happens that Delaware has also adopted Rule 23.1 and Rule 23.1 counsels that an action shall not be dismissed or compromised without approval of the courts and without notice of the proposed dismissal to the stockholders. Now --

QUESTION: This was not the basis for the Court of Appeals decision.

MR. EINSTEIN: That is correct, Your Honor, it was not but I believe that there is the basis of judgment here, is Rule 23.1 and the rule 23.1 mandates a hearing before the district court and it mandates that the district court examine the merits of the action, look into independence, look into disinterestedness, look into the reasonableness of the proposed dismissal.

In those regards I believe Rule 23.1 is very close to the standards suggested by the Commission. I think the Commission need not draw its --

QUESTION: Well, yes but at the hearing suppose it said, here is the governing law in Delaware for the way directors are supposed to act. Now, what does 23.1 add to --

MR. EINSTEIN: The governing law in Delaware is that directors, as it is everywhere else, can be disqualified to act if they are interested in the event.

QUESTION: Yes, yes.

MR. EINSTEIN: And here you have, you know, a majority of a board of directors interested in the results. It is only a minority.

Now, I will concede to Your Honor there have been very, very few disqualified --

QUESTION: I can understand that you are making an argument now that state law would have barred this dismissal.

MR. EINSTEIN: I think it well would have, Your

Honor. I think it well would have.

QUESTION: Well, I doubt if we would have -- I doubt if the case would be before us then, if that was --

MR. EINSTEIN: The district court --

QUESTION: What you are arguing for is that whatever state law would provide, federal law requires a different standard. That is your argument.

MR. EINSTEIN: I find no difference between the standards. In other words, Your Honor, I think the Second Circuit was correct in its view of this case under the Investment Company Act of 1940. I do not believe that that is the only basis on which the case necessarily had to be decided because I think if you looked at state law or Rule 23.1, both the Deleware version and the federal version which are identical, you reach the same result.

QUESTION: Well, your opposition I would not think would disagree with you on looking to state law. They might disagree with you on what state law is but they certainly say state law controls.

MR. EINSTEIN: Well, that may be so, Your Honor, but I find no difference between the results dictated by either state or federal law. Indeed, in terms of the discretion of the board of directors, I would read to the Court from its decision in United Copper which says at page 263 of 244 U.S., "Courts interfere seldom to control such discretion intravires the corporation except where the directors are guilty of misconduct equivalent to breach of trust or where they stand in a dual relation which prevents an unprejudiced exercise of judgment."

Now, under those standards I think it is very clear that this minority of the board could not act and the board could not act.

QUESTION: Well, what you are saying would lead me to believe that you, if you want to, can file another derivative suit on behalf of the corporation grounded upon the wrongful action of these directors in making this business decision to settle this lawsuit.

MR. EINSTEIN: I do not think that --

QUESTION: That is where your claim should appropriately be tested out, is it not?

MR. EINSTEIN: No, I think my claim can be properly tested out in the district court which has a duty --

QUESTION: Well, that would be in the district court.

MR. EINSTEIN: No, in this action, after all, we are now six years since this action was filed and still in the preliminary procedures without ever having an answer filed or any discovery and I think that the claims can be tested out in the district courts which can easily and under very familiar standards deal with all these questions.

QUESTION: It is generally the business of directors who are fiduciaries with respect to the shareholders to make business decisions on behalf of the corporations. The district court found that these were disinterested directors, both in fact and within the meaning of the federal statute, that they acted by a majority of the quorum and that they acted in good faith and why is this business decision any different from any other business decision that the directors are entrusted with making?

MR. EINSTEIN: Because they seek to exculpate the majority of the board from serious substantiated charges of wrongdoing, that is why it is different. They are not --

QUESTION: Your original action was brought on the, for the corporation on behalf of the corporation.

MR. EINSTEIN: That is right.

QUESTION: And now these directors are acting on behalf of the corporation.

MR. EINSTEIN: But they are seeking to exculpate fellow directors.

QUESTION: Well, whatever they are seeking to do, they are making business decisions for the corporation, like any other business decision for the corporation and if you think that they acted wrongly you can bring on another stockholders' derivative suit --

MR. EINSTEIN: I think that under the --

QUESTION: -- on behalf of the corporation, against them.

MR. EINSTEIN: -- I think that under the standards of Rule 23.1 I do not have to go through that procedure, that I can present those arguments and have them considered by the district court.

QUESTION: Is there anyting in Rule 23 against dismissing or compromising without consent of the court?

MR. EINSTEIN: There is, Your Honor.

QUESTION: That is correct.

MR. EINSTEIN: That is (e) .1.

QUESTION: 23.1.

MR. EINSTEIN: 23.1. 23 is class action. 23.1 is derivative action.

QUESTION: Oh, yes.

QUESTION: 23.1 says that you need the approval of the district court.

MR. EINSTEIN: That is correct and they got the approval of district court. In the case law, first of all it requires notice to the stockholders and the case law that has surrounded Rule 23.1 has made it very clear that the court has to consider the propriety of the dismissal, the business judgment reasons, the merits of the action, to make sure that dismissal is proper.

QUESTION: And those cases all deal with dismissals by the shareholders who are suing on behalf of the corporation, where the evils are quite different and those are the evils to which this rule is directed. Everybody knows that.

MR. EINSTEIN: With all deference, Your Honor, there are a number of cases which we have cited in our brief where a majority of a board of directors of a new board that has turned over during the course of a litigation, has come into court to seek dismissal of a derivative action and in each of those cases and they are cited at pages 49 through 50 of our brief, in each of those cases, where a majority, a new and concededly independent majority came into the corporation, the court conducted a painstaking, extensive hearing to determine whether dismissal was appropriate.

Now, that is Birnbaum against Birrell decided by Cheif Judge Edelstein in the Southern District of New York decided that; Berger against Dyson; Denicke against the Anglo California National Bank all decided that and indeed, Goodwin against Castleton, a Washington case, also reached the same results.

In other words, the courts in all of those cases, even where a majority of the board came in and asked for dismissal, refused to simply rubberstamp the dismissal.

They examined the merits of the action. They examined the business judgment reasons and only then, if the court deemed it proper, was the derivative action permitted to be dismissed.

Now, I think that is very different than what occurred here.

QUESTION: Well, in each case as I, just reading them I am not familiar with them. I have not read the opinions but in Birnbaum against Birrell and Berger against Dyson, as I read this little discription in your brief, the shareholder plaintiffs received something too, did they not?

MR. EINSTEIN: Yes, they did. And the corporation received something. In each of those cases there was consideration running to the corporation in connection with the settlement.

Here, the corporation received nothing. This case is being dismissed without any compensation to the corporation.

I think that heightens the obligation of the court to see that the dismissal is in the best interest of the shareholders.

QUESTION: Well, it is apparent, then, that the rule you are advancing would certainly, I suppose, a fortiOari or not, apply to compromises?

MR. EINSTEIN: Yes, I am --

QUESTION: If the directors wanted to compromise a suit and wanted to settle it, they could not do so over the objection of the plaintiffs even if state law would give them that power.

MR. EINSTEIN: Well, I question whether Delaware law gives the minority power.

QUESTION: Yes.

MR. EINSTEIN: If there was a majority of directors that decided to do it, I think the Court would have the obligation to examine the compromise to make sure it was fair and appropriate. Who is to say that the new board may not have had some kind of an arrangement with the defendant? You never know that.

QUESTION: Was there not, under Delaware law, majority action here by a quorum of the directors?

MR. EINSTEIN: There was quorum action. It is a minority. It is five out of eleven directors. Now --

QUESTION: Yes but that is the law of Delaware, is it not?

MR. EINSTEIN: The law of Delaware says that a quorum can be a minority. The law of Delaware also says that when you bring a derivative action and a majority of the board is charged with wrongdoing you do not have to make a demand. That is federal law and that is Delaware law.

Now, if you do not have to make a demand where there is a minority quorum in order to bring a derivative action, does a litigant then every month or every year when there is a new election have to make a new demand because maybe the composition of that board has changed?

Or if you follow it to its end if there is a minority quorum, do you have to make a demand on that minority, let it act and then have a threshold litigation on the appropriateness of minority action?

QUESTION: We do not have any of those hypotheticals here, do we?

MR. EINSTEIN: I think that is where the flaw is in my adversary's position because Rule 23.1 and the decisions under it, both federal and Delaware, grant access to the courts, to the federal and the state courts whenever a majority of the board is charged with wrongdoing without the necessity of a demand.

Now, if you are in court on that theory, I do not see how or why it is appropriate to have the same minority turn around the next day or the next week or the next month and spin you right back out of court again.

I do not think Rule 23.1 contemplates it or the Delaware law contemplates it.

QUESTION: Of course, in a federal court in a derivative action, unless there is some federal statute, the state corporation law is going to govern, is it not?

MR. EINSTEIN: That is correct. And the state corporation law of Delaware is, in effect, Rule 23.1 and the decision --

QUESTION: You would not think -- do you think under 23.1 the district judge could just say, I am just not going to approve a settlement because this is just by a majority of a minority quorum.

MR. EINSTEIN: I think the district court -- well, I have serious question, Your Honor, about whether a minority has the standing or the power to bring the question before the board.

QUESTION: Well, suppose it does.

MR. EINSTEIN: Let us assume it does.

QUESTION: And it is clear under Delaware law that it does.

MR. EINSTEIN: All right, let us assume that it has.

QUESTION: Could the district court just ignore that and say, I am not even going to consider it?

MR. EINSTEIN: No, the district court would have to consider the application and weigh it on the merits, is the dismissal in the best interest of the stockholders? Is the quorum group independent? What are the reasons which allegedly support dismissal? What is the merit of the action? What are all the relevant factors? And then make an informed judgment.

District courts do this all the time in settling class and derivative actions under Rules 23 and 23.1. This is nothing new. It is nothing extraordinary. It does not broaden the burdens or obligations of the district court.

I am not suggesting -- as I think some concern was expressed before -- that an entirely new procedure be created, that there need be full discovery as if the case was being prepared for trial on the merits. All that is required is that the district judge afford the objecting party an opportunity for reasonable discovery in the discretion of the judge and then pass on these issues.

There have been many cases, Your Honors, where district courts have refused settlements because they thought they were unreasonable and I think that the district court has that power and authority.

Now, I would like to pass onto one other matter and that is the fact of the subsequent removal of Anchor as the fund's advisor because I think that that is a matter of great significance in this litigation.

Anchor is no longer the advisor and one of the alleged motivating factors in connection with the action of the minority directors here was that continued litigation would so adversely affect the fund's relationship with Anchor that that relationship would be destroyed.

Since the relationship no longer exists I have serious doubt as to whether there is any further basis for dismissal of this action.

Now, I would call the Court's attention to the decisions in McLeod against General Electric 385 U.S. 533 and Patterson v. Alabama 294 U.S. 600 and I read the citations because they are not in our brief -- which clearly indicate that when there is a set of circumstances which has occurred between the time of a decision and the time of a hearing in this Court, this Court can and should look to these additional facts and circumstances in reaching its decision and Korne against Franchard which is reported at 456 Federal 2nd 1206 indicates that where the circumstance is so strong and compelling as I believe this one is, that it mandates a different result or I believe in our case it would mandate an affirmance because it undercuts the decisions for, the reasons for dismissal, that the court can grant the appropriate relief and need not merely remand the case for another look in the lower courts.

In sum --

QUESTION: With regard to the cases you gave, I think some of us were not aware that you were referring to noncited cases.

MR. EINSTEIN: Right.

QUESTION: Would you give me the Supreme Court cites again?

MR. EINSTEIN: McLeod versus General Electric 385 U.S. 533; Patterson v. Alabama 294 U.S. 600 and the Second Circuit case is Korne v. Franchard 456 F 2nd 1206. I had not cited these because the issue of this Court's ability to consider this fact was only raised in my adversary's reply brief to which I of course --

QUESTION: Is Patterson a criminal case?

MR. EINSTEIN: I believe Patterson was a criminal case.

QUESTION: The Canterbury case.

MR. EINSTEIN: I believe so.

QUESTION: I do not see how that could apply to this.

MR. EINSTEIN: Well, what those two cases stand for, McLeod is an NLRB case and Korne against Franchard is a class-action decertification case. All of them clearly indicate that where a subsequent fact has occurred after the decision but before the hearing of the appeal, the court can and should look at that subsequent fact and take the appropriate action.

In summary, Your Honors, I would submit that the decision of the Second Circuit is clearly correct within the narrow confines of the case as decided by that court when you look at the specific facts at Bar and consider them in light of the history and purposes of the '40 Act, we believe that the decision was correct.

We also believe -- excuse me, Mr. Justice White.

QUESTION: The district judge, I suppose, thought he was complying with Rule 23?

MR. EINSTEIN: The district judge rejected the position that Rule 23.1 was applicable. The question was briefed in the Second Circuit but never reached by the court because --

QUESTION: He said that Rule 23 has nothing to do with it whatsoever.

MR. EINSTEIN: That is correct, it did not apply. And the district court and the Second Circuit found it unnecessary to reach the question.

Now, we also believe, Your Honors, that if you do not follow the rationale of the Second Circuit and view the case as one under 23.1 requiring hearing as a prerequisite to dismissal and when you look at the factors that the Court must consider, that on this record, especially given the subsequent termination of Anchor as the Fund's advisor, there is no rationale or reasonable basis for dismissal of this action.

The action should be allowed to proceed. The alleged harm which the fund perceived it could suffer by further prosecution of this action is no longer existent.

QUESTION: I do not understand, if we agreed with you on 23.1 and the district court refused to apply it and we think he should have, why would we not send it back for him to apply it?

MR. EINSTEIN: Because when you look at the factors that Rule 23.1 requires, Mr. Justice Brennan, consideration of the merits, the Court of Appeals has found there was merit.

The question of independence, the Court of Appeals questioned that and the so-called "business judgment reasons," the reasonableness of the decision particularly, you find that the business judgment reasons no longer exist because of the termination of Anchor.

QUESTION: But in the first instance, if you are right, Section 23.1 contemplates that it is the district court who shall make the initial judgment whether 23.1 shall satisfy.

MR. EINSTEIN: Yes but if you sent it back to the district court and the district court refused again to dismiss and your view of the case today was that it had to be retained, it could not be dismissed, we would just have an up and down procedure again without any reason or purpose.

QUESTION: Well, we might affirm a judgment that we might not have made in the first instance ourselves, just because it might rest on findings that are clearly erroneous.

MR. EINSTEIN: That is correct, Your Honor but I think in this case with the removal of Anchor, the facts are so clear that they mandate only one result and that is the rationale and teaching of Korne against Franchard which I cited to the Court before.

I see my time is done. Thank you, Your Honors.

QUESTION: Do your clients still own the shares of --

MR. EINSTEIN: Yes, Your Honor.

QUESTION: How many shares do they own, as a matter of interest?

MR. EINSTEIN: I think about 200 each, Your Honor.

QUESTION: Four hundred out of how many?

MR. EINSTEIN: Well, there is -- I know there is 120,000 -- 140,000 stockholders of the fund. It is quite a large fund. There are many millions of shares outstanding. I do not recall the number.

MR. CHIEF JUSTICE BURGER: Mr. Pollack.

REBUTTAL ARGUMENT OF DANIEL A. POLLACK, ESQ.

MR. POLLACK: Mr. Chief Justice and again, may it please the Court:

Rule 23.1 as relied on by Mr. Einstein has nothing to do with this case. It involves settlements by plaintiffs and the vice sought to be eradicated there is collusive settlements where a plaintiff drops a suit. This is not a case of an involuntary dismissal. This is a case where the matter was litigated on the merits before Judge Werker and he dismissed the case on an involuntary basis.

I want to bring the -- respectfully bring the attention of the Court back to the central issue in this case. The Court of Appeals found that as a matter of law disinterested directors had no power to terminate this stockholders' derivative action.

I have listened carefully to the discussion this morning and I believe the briefs also support the proposition that no one has cited any authority indicating that the Act expressly deprives this power from the directors, that the history of the Act deprives the directors of this power or that the relevant case law under the Act deprives the directors of this power.

Mr. Ferrara has indicated in his brief for the government that the SEC supports the notion that the directors have the power and that the power has not been withdrawn by the act.

All that he says is that there should be a remand. But I call to the attention of the Court the final footnoote in the brief of the Commission.

I believe the microphone may have gone off again.

MR. CHIEF JUSTICE BURGER: No, it is still functioning.

MR. POLLACK: Thank you, Mr. Chief Justice.

MR. CHIEF JUSTICE BURGER: What is the number of the footnote?

MR. POLLACK: 21. Footnote 21 says, "Although we suggest a remand, this Court could determine reasonableness if it wishes because that determination involves only the application of a legal standard to a documentary record."

Now, if this Court can determine reasonableness from this record, surely Judge Werker could and we argue, implicitly did make a finding of reasonableness if this Court should find that that is necessary.

Therefore, we come back to the proposition that although we believe that state law governs and that that is the test to be applied, that is to say, the test of good faith, no matter which of the tests that have been proposed here, we believe that we meet that test.

Judge Werker found -- and I cite this to the Court at A 36 -- that the minority directors carefully evaluated the opinions tendered by both counsel. They considered the merits. They discussed the facts and circumstances surrounding the purchase and retention of the paper and they communicated extensively among themselves before reaching a decision to seek dismissal of this suit.

I believe that this is precisely the type of directorial conduct that one wishes to encourage.

Thank you very much for your time.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

[Whereupon, at 1:25 o'clock p.m., the case is submitted.]