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Jan Ginter Deutsch
Yale Law School

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Fogel v. Chestnutt: The Meaning of an Opinion

Jan G. Deutsch*

Introduction

Extraordinary capacity as a technician is a necessary but not sufficient basis on which to claim the designation of expert. The differentiating aspect is what separates an art from a science, what is learned during apprenticeship as opposed to what can be taught to a student. Within any given field, the technician shares with the expert mastery of the individual objects in terms of which the field itself is defined. The mastery of the expert, however, is also informed by an awareness of the differences produced by variations in the ways those objects are perceived, by what is often referred to as style, rather than substance. What follows is a study in style, and it is assumed that readers are acquainted with the substance of the judicial opinions being analyzed. The attempt is to demonstrate that such mastery is the beginning, rather than the culmination, of the endeavor of understanding.

By providing the link between rationale and result that distinguishes law from fiat, the judicial opinion represents the difference between justice and power. As a consequence, how an opinion is written is important for what it tells the reader about what the law is perceived to be, just as, for the litigator, it is important for the information it communicates about the perspective being brought to bear on the controversy being described. Judicial style, in short, is a matter too human in scope to be left to connoisseurs of opinion writing.

The Opinion

The specific matters under discussion in this article are the import of the formulation of the issue addressed in the Fogel v. Chest-
opinion as the need, "more than four years after the First Circuit decided Moses v. Burgin, 445 F.2d 369 (1971), reversing 316 F. Supp. 31 (D. Mass. 1970), concerning the duty of the managers of a mutual fund to recapture brokerage commissions for the benefit of the fund . . . [to] determine whether we agree with the First Circuit's decision . . ." and the significance of the fact that so much of the opinion, in terms both of what was described and what was stressed, is devoted to the activities of an administrative agency.

The Basis of Liability

After two sections devoted to administrative developments and one to describing the proceedings in the district court, Section IV of the opinion addresses the issue of "the basis of liability." After noting that "the obligations entailed by the contract theory might well be more severe than those entailed by the theory of breach of fiduciary duty," the opinion rejects the former theory—that [recapture] efforts were required by Fund's certificate of incorporation—on this basis:

"Although the argument is not without force, we think it presses too far. The term 'net asset value' is one of art in the mutual fund industry and is elaborately defined in the certificate of incorporation. The objective of the charter provision was to prevent dilution of per share net asset value by the issuance of new shares at a discount; defendants' failure to recapture part of the commissions on portfolio transactions does not result in such dilution. Plaintiffs' real complaint is not that new shareholders did not pay net asset value but that the Adviser, for selfish motives, refrained from handling portfolio transactions in a manner that would have diverted a portion of the commissions to itself, with an attendant decrease in the advisory fee—in substance a charge of breach of a fiduciary duty resulting in corporate waste."

The writer of the opinion had demonstrated a similar regard for, and emphasis on, what he perceived to be the realities of the business world and the impact of judicial opinions on that world in Essex Universal Corp. v. Yates, where the legal question at issue—the validity of a specific contractual provision—produced three opinions on the question of how the judiciary could determine whether a given bloc of securities "controlled" the corporation:

"Attractive as [Judge Lumbard's] proposal is in some respects, I find difficulties with it. One is that I discern no sufficient intimation of the distinction in the New York cases, or even in the writers, who either would go further in voiding such a clause . . . or believe the courts have not yet gone that far . . . To strike down such a condition only in cases falling short of the suggested line accomplishes little to prevent what I consider the evil; in most instances a seller will not enter into a contract conditioned on his 'delivering' a majority of the directors unless he has good reason to think he can do that. When an issue does arise, the 'practical certainty' test is difficult to apply. The existence of such certainty will depend not merely on the proportion of the stock held by the seller but on many other factors—whether the other stock is widely or closely held, how much of it is in 'street names,' what success the corporation has experienced, how far its dividend policies have satisfied its stockholders, the identity of the purchasers, the presence or absence of cumulative voting, and many others. Often, unless the seller has nearly 50% of the stock, whether he has 'working control' can be determined only by an election; groups who thought they had such control have experienced unpleasant surprises in recent years."

Equally noteworthy, however, is the extent to which the proposed solution focuses on requirements which, given the stress on the view that "developments over the past decades seem . . . to show that such a [contractual] clause violates basic principles of corpo-
rate democracy," could fairly be described as technical:

"To hold the seller for delinquencies of the new directors only if he knew the purchaser was an intending looter is not a sufficient sanction. The difficulties of proof are formidable even if receipt of too high a premium creates a presumption of such knowledge, and, all too often, the doors are locked only after the horses have been stolen. Stronger medicines are needed—refusal to enforce a contract with such a clause, even though this confers an unwarranted benefit on a defaulter, and continuing responsibility of the former directors for negligence of the new ones until an election has been held. Such prophylactics are not contraindicated, as Judge Lumbard suggests, by the conceded desirability of preventing the dead hand of a former 'controlling' group from continuing to dominate the board after a sale, or of protecting a would-be purchaser from finding himself without a majority of the board after he has spent his money. A special meeting of stockholders to replace a board may always be called, and there could be no objection to making the closing of a purchase contingent on the results of such an election. I perceive some of the difficulties of mechanics such a procedure presents, but I have enough confidence in the ingenuity of the corporate bar to believe these would be surmounted." 10

Since the contractual basis for the liability of mutual fund directors has been accepted by the Moses court,11 the Fogel opinion notes that "a comment on Moses raises the question why, if this theory were sound, the court went on with an extensive discussion . . . of management's duty to make full disclosure to the unaffiliated directors and the apparent resting of liability upon that ground." 12

The Fogel Standard

The Fogel opinion begins its analysis of the theory of breach of fiduciary duty by noting that it takes "a less expansive view" 13 of the section of the Investment Company Act, "as originally enacted," 14 on which the Moses court predicated federal jurisdiction and whose standards it "seemingly also held" 15 had been violated.

The standard the Fogel opinion applies it finds to entail "a duty which [a] 1970 amendment makes explicit." 16 It agrees with the Moses court, however, that "under the scheme of the Investment Company Act an investment adviser is 'under a duty of full disclosure of information to . . . unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund'—a situation which occurs much more frequently in the relations between a mutual fund and its investment adviser than in ordinary business corporations. . . ." 17

The basis for liability thus adumbrated raises, of course, the considerable issue of the extent to which a legal duty can legitimately be held to govern acts occurring before it was made explicit. Given the focus of this article on the use of the Moses precedent, however, and the stress of the Fogel opinion on the varying impacts of different legal theories, 18 it seems more relevant that a Southern District of New York opinion, 19 rendered five months prior to Fogel, noted that "the Burgin formulation has not been adopted in this circuit," 20 and that "in view of the developments since Burgin one can be certain that whatever doubts might exist as to whether its basic thrust was non-disclosure, rather than a mandate that regional exchanges be utilized to secure 'give-ups' for reduction of management fee, there is little doubt in my mind that non-disclosure is the only precedential value that Burgin now retains." 21

After reviewing the testimony given in the trial court, the Fogel opinion concludes that "this does not add up to the effective communication of a problem to the independent directors mandated by Moses," 22 although it notes that "to be sure, we do not have in this

9 Id. at 581.
10 Id.
11 "A similar argument, made by the same counsel, was accepted in Moses v. Burgin." Note 1 supra, at 744.
12 Id.
13 Id. at 745.
14 Id.
15 Id.
16 Id.
17 Id.
18 See text at note 4 supra.
20 Id. at 950.
21 Id. at 950-951.
22 Note 1 supra, at 749.
case direct suggestions from the staff of the SEC such as those discussed in Moses." 23

Given that the Fogel opinion resulted in a reversal of the result reached by the district court, it seems significant that it concluded its review of administrative developments with "the Securities Act Amendments of 1975, 89 Stat. 97, which, of course, were not available to [the district court]." 24 Again, given the focus of this article, the significance of the reference to the 1975 Amendments is less the specific benchmark is provided in connection with the issue of making legal duties retroactive 25 than the extent to which it highlights an appellate court's use of administrative activities to justify reversing the conclusions reached by a trial court. Thus, in Moses, Judge Wyzanski's opinion was such that the First Circuit explicitly noted:

"We are urged at length by defendants, in common with most appellees who come before us with findings in their favor, that we have no power to review the evidence de novo. We recognize this, and strive not to do so. This is not to say, however, that we cannot reverse findings which are unsupported by the evidence, or which are so contrary to the great weight of the evidence as to compel the conclusion that a manifest error has been done, and in such circumstances make the opposite finding. Nor does it mean, where no finding has been made at all, that we cannot make our own findings, provided that the great weight of the evidence would compel such a conclusion." 26

Moreover, the importance of the "direct suggestions from the staff of the SEC" 27 stems from the fact that, in Moses:

"The district court found untrue plaintiff's claim that Management 'consistently kept from the directors any of the information which might have aroused them from their inaction.' This finding is supportable only in the sense that the concealment was not 'consistent.' In any other sense it is plainly erroneous as to NASD recapture in the light of the knowledge Management concededly possessed which could well have aroused the unaffiliated directors. As will be developed, the inescapable fact is that Management defendants did, for an extended period of time, keep to themselves possibly, we would say probably, stimulating information." 28

Given this history, the Moses precedent may represent simply a declaration that the power possessed by trial courts as finders of fact 29 is necessarily limited by the power of appellate courts as declarers of law. Viewed in this light, the Fogel opinion is a political document, whose focus is the activities of federal trial and appellate judges. Without denying that the judicial opinions can validly be viewed as political documents, however, it must be

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23 Id.
24 Id. at 743 (footnote omitted).
25 "A recent amendment, Section 6, Securities Acts Amendments of 1975 (Pub. L. 94-29), to the securities law would appear now to bar Eberstadt from any involvement in the portfolio transactions of the Fund. The plaintiff properly points out that the new amendment applies only after May 1, 1978, and does not affect defendants' liability prior thereto. This, of course, is true. Moses v. Burgin, viewed in the light of the amendment and the modification in SEC approach between 1966 and the present to the question raised here, must be interpreted to accord with decisions holding that a requirement of full disclosure and lack of misrepresentation encapsulates the impact of the federal securities laws. Moreover, the new law undergirds the flooring on which the court's view is based that the Fund policy under attack is clearly an exercise of sound business judgment and outside the reach of the jurisdiction of this court. In summary, I find no basis for liability under either the federal securities law or the common law."


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26 Moses v. Burgin, 445 F.2d 369, 373 n.6 (1st Cir. 1971).
27 See text at note 23 supra.

"Under the theory of the case for plaintiffs, it is necessary for them to show that Fund or Adviser could have formed a subsidiary which could have properly become a member of NASD.

"Counsel for defendants ignore this issue and offer no help to the Court. *

"The principle is accepted that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions. It is not shown that defendants could have properly secured any return for Fund."
noted that the audience to which they are addressed is wider than the federal judiciary.

**The Fogel Opinion and the Business World**

The *Fogel* opinion demonstrated sensitivity to this wider audience, to the impact of its determination on the business world, when, "in remanding to the district court for the determination of damages," it noted:

"The *Moses* result may appear somewhat harsh, particularly in a case like this involving a medium-sized no-load fund where there were stronger business reasons against seeking recapture, at least for the period when reciprocals or give-ups to brokers in return for sales efforts were in vogue. However, we think the considerations against allowing defendants to attempt to prove that, after independent investigation by the disinterested directors, the board might reasonably have concluded not to recapture, or at least not to go all out for recapture, . . . similarly foreclose defendants with respect to damages, as long as damages are limited to the business as actually conducted." 31

The corporate law decision which could function as the precedential basis for the distinction between breach of duty and liability for damages by a corporate director is the Learned Hand opinion in *Barnes v. Andrews*, 32 in which it was held that although the court "cannot acquit Andrews of misprison in his office . . ." 33 "the plaintiff must accept the burden of showing that the performance of the defendant's duties would have avoided loss, and what loss it would have avoided." 34

The ultimate rationale for this holding was delineated by Hand five years later in an address to the American Law Institute:

"For many ages, for thousands of years indeed, mankind lived along without being able to change at all the traditional codes which regulated the details of their lives. Custom had the sanction of the gods and being divine, men feared to meddle with it. In civilized times we have indeed acquired that power and it is upon it that we must rely if we are to say that we are governed by our common consent. In one way or another we set up officials who innovate, and when they do, we call it our common will at work. This we have made the cornerstone of our structure. Our common law is the stock instance of a combination of custom and its successive adaptations. The judges receive it and profess to treat it as authoritative, while they gently mould it the better to fit changed ideas. Indeed, the whole of it has been fabricated in this way like a coral reef, of the symmetry of whose eventual structure the artificers have no intimation as they labor." 35

The consequences of this view of the judicial function became clear in the Oliver Wendell Holmes Lectures of 1958, in which Hand concluded:

"I have tried to strike a balance between the advantages of our own system and one in which we might enjoy at least the protection of judges against our frailties. To me it seems better to take our chances that such constitutional restraints as already exist may not sufficiently arrest the recklessness of popular assemblies." 36

Further, he found that "it is as craftsmen that we [judges] get our satisfactions and our pay." 37

In contradistinction to this viewpoint, the *Fogel* opinion utilized the skill of the craftsman precisely to avoid being governed by the fact that "prior to December 5, 1968, it was common practice, custom and usage for a mutual fund through its manager to direct executing brokers on the NYSE and other national securities exchanges to 'give up' part of their commission to other exchange members who had no part in the execution of the transaction." 38

It must be noted, however, that in the Charles Evans Hughes

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30 *Id.* at 755.
31 *Id.* at 756 (footnote omitted).
33 *Id.* at 616.
34 *Id.*
37 *Id.* at 77.
38 Tannenbaum v. Zeller, note 19 *supra*, at 945, 947 (footnote omitted).
Lecture of March 21, 1963, which took as its text Lord Devlin’s sentence that “the work done by the Judges of England is not now as glorious as it was,” Judge Friendly noted:

“[T]he legislature’s superior resources for fact gathering; its ability to act without awaiting an adventitious concatenation of the determined party, the right set of facts, the persuasive lawyer, and the perceptive court; its power to frame pragmatic rules departing from strict logic, and to fashion a broad new regime or to bring new facts within an existing one; its practice of changing law solely for the future in contrast to the general judicial reluctance so to proceed; and, finally, the greater assurance that a legislative solution is not likely to run counter to the popular will: all these give the legislature a position of decided advantage, if only it will use it.”

As a result:

“I... do not at all lament the diminished role of the judge vis-à-vis the legislator as a maker of law. What I do lament is that the legislator has diminished the role of the judge by occupying vast fields and then has failed to keep them ploughed...

“My criticism is directed rather at cases in which the legislature has said enough to deprive the judges of power to make law even in such subordinate respects but has given them guidance that is defective in one way or another, and then does nothing by way of remedy when the problem comes to light.”

In terms of the law applied to the mutual fund directors whose actions were the subject of the Fogel opinion, it seems clear that the detailed provisions of the Investment Company Act and the ongoing efforts of the SEC to regulate the activities of the mutual fund industry have considerably constricted the scope of the area governed by a single judicial decision. Given the substance of Fogel, in short, the distinction between the technician and the expert has become a narrow one.

As to the meaning of this narrowing in terms of the vision of law held by our society, it seems to me significant that Judge Wyzanski concluded his 1963 Introduction to the 1958 Oliver Wendell Holmes Lectures in the following terms:

“Judges who daily exercise constitutional power exercise more latitude in cases of statutory construction and of common law rules than do judges whose experience lies in more conventional professional paths. And yet, completely to follow Judge Hand’s teachings and to take his strict canons of judicial review, would open, at the present stage in our history, possibilities of political tyranny of far greater dimensions than anything within the scope of judicial caprice.

“Unless I am mistaken, the people of the United States have consciously chosen to adhere to the institution of judicial review because they enjoy a larger measure of democracy within its framework than they would without it. And so long as there are judges with the skepticism, tolerance, and humility of Judge Hand to remind us how cautiously judges should proceed, this popular delegation to the judiciary is not likely to be revoked.”

The Substance of Fogel v. Chestnut

This section of the article attempts to delineate the sense in which the following holding of Fogel v. Chestnut embodies the dangers inherent in the narrowing of the vision of law held by our society:

“We therefore conclude that liability exists with respect to the Adviser and the defendants Chestnut, Sabel and Greene. Under the principle laid down in Moses, we would see no basis for imposing liability on directors who were not interested. While we do not rule on the apportionment of liability, equity would suggest the imposition of primary responsibility on the Adviser, which profited from the failure to recapture.”

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40 Id. at 792.
41 See text at notes 13, 14 supra.
42 See text at notes 27, 28 supra.
43 Hand, note 36 supra, at xiv.
44 Note 1 supra, at 750.
In terms of the world in which directors are active, what is remarkable about this holding is that it is precisely the unaffiliated directors who are intended to represent the interests of the fund shareholders free from the conflicts of interest inherent in the role of the adviser. In terms of corporate law precedents, the imposition of liability solely upon interested directors could be supported by the citation of Meinhard v. Salmon, in which Cardozo explicitly noted that “Meinhard, who had given money, but neither time nor labor, had already been richly held, in the paragraph that is regularly cited as the justification for the imposition of a fiduciary duty:

"Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbreakable and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ‘disintegrating erosion’ of particular exceptions. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court."  

Salmon, however, was a case that dealt with a partnership and a real estate lease, and in this sense, a demonstration of the problem raised by the constriction of the area governed by a judicial opinion, the possibility that “the work done by [common-law judges] is not now as glorious as it was,” is that Salmon is not perceived as a decision whose significance is governed by those facts. As to the relevance of Salmon to Fogel v. Chestnutt, it was Judge Friendly, in Essex Universal Corp. v. Yates, who lamented the fact that “here we are forced to decide a question of New York law, of enormous to all New York corporations and their stockholders, on which there is hardly enough New York authority for a really informed prediction what the New York Court of Appeals would decide on the facts here presented . . . yet too much for us to have the freedom used to good effect in Perlman v. Feldmann.”

The transaction held violative of fiduciary duty in Perlman, however, was the very same transaction under scrutiny in a suit that was dismissed because no violation of federal securities legislation could be demonstrated, and “jurisdiction in this case is not predicated upon diversity of citizenship,” despite these allegations:

“Feldmann violated Rule X-10B-5 when he reported by letter to Newport stockholders about the negotiations with Follansbee but failed to disclose his personal interest in its rejection. In addition, there are allegations that Feldmann and the other directors resigned pursuant to the terms of the sale to Wilport; and that Wilport, a corporation owned by ten large users of steel, was using, and intending to use, Newport as a ‘captive’ subsidiary. Plaintiffs ask that all defendants, save Newport, be directed to account, that defendants Wilport, Gibson, Mericka, Mitchell, Cobourn and Paxton, directors and officers of Wilport, be enjoined from causing Newport to sell exclusively to Wilport; and that the sale of Feldmann’s stock be declared void.”

The corporate law precedent holding valid what is, in a sense, 

45 See also id. at 749-750, including n.18:

“The minimum requirement to enable the Fund’s independent directors to discharge those duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors. This was done in Moses but the court found that counsel had not been sufficiently informed.”

46 249 N.Y. 45, 164 N.E. 545 (1928).

47 Id. at 468, 164 N.E. at 548.

48 Id.

49 Id. at 464, 164 N.E. at 546.
the paradigm of directorial fiduciary duty—action even in the face of explicit action to the contrary by a majority shareholder interest—was rendered by the Court of Appeal of England in 1906 and involved a transaction perceived as involving violations of duties strikingly similar to those implicitly underlying the Birnbaum allegations:

“The plaintiff A.H. McDiarmid, who was the holder of 1,202 shares in the plaintiff company, being desirous that the assets and undertaking of the plaintiff company should be sold, arranged terms on behalf of the company for the sale of them to a new company formed for the purpose of acquiring them, and had these terms embodied in a contract which was engrossed ready for execution by the company.” 54

“Practically the whole of the 1,502 votes were given in respect of shares held by the plaintiff McDiarmid or his friends.

“The directors, being of opinion that it would not be in the interests of the plaintiff company that the contract should be carried out, declined to comply with the resolution.” 55

54 Automatic Self-Cleansing Filter Syndicate Co. v. Cunningham, [1906] 2 Ch. 34, 36.
55 Id.

FANCY BOUGHT MONEY

“I maintain that the Money Market is as concrete and real as anything else; that it can be described in plain words; that it is the writer’s fault if what he says is not clear.”

—Walter Bagehot (1873)