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THE MASSACHUSETTS BUSINESS TRUST AND REGISTERED INVESTMENT COMPANIES

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I. INTRODUCTION

The investment company[1] industry is a significant factor in the United States economy. As of December 31, 1987, there were 2,324

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1. As defined in the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (1987), "investment company" means any issuer which:

> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
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> (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
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> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

15 U.S.C. § 80a-3(a)(1)-(3).

Investment companies are divided into open-end and closed-end companies, defined as follows:

> (1) "Open-end company" means a management company which is

investment companies in the United States holding $769.9 billion in assets.[2] During the period July 1985 through December 1987, 448 of the 904 new investment companies which registered under the Investment Company Act of 1940 (the 1940 Act),[3] or 50% of the total, were Massachusetts business trusts.[4] Next in popularity for investment organizations was the Maryland corporation at 28%.[5] What is a Massachusetts business trust? Why is it so popular?

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offering for sale or has outstanding any redeemable security of which it is the issuer.

(2) "Closed-end company" means any management company other than an open-end company.

15 U.S.C. § 80a-5(a)(1)-(2).

Open-end investment companies generally sell their own new shares to the public continuously. Closed-end investment companies generally have fixed capitalization and shares which trade in the open market. New York Stock Exchange, Inc., *The New York Stock Exchange Glossary* (1984).

2. INVESTMENT COMPANY INSTITUTE, 1988 MUTUAL FUND FACTBOOK 62, 64 (1988).

3. 15 U.S.C. §§ 80a-1 to -64 (1982). The term "company" is defined in the 1940 Act to mean "a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not . . . ." *Id.* § 80a-2(a)(8).

4. Information obtained from *Simon's Mutual Fund Monthly*, issue 6, July 1985 through issue 35, December 1987. *Simon's* reports all new investment company registrations except for unit investment trusts and some insurance company separate accounts.

5. *Id.* Effective July 1, 1987, Maryland amended its corporate statute, 1987 Md. Laws ch. 242, to make a Maryland corporation even more competitive with the Massachusetts business trust as a form of organization for investment companies registered under the 1940 Act, and, as a result, many investment companies are currently being organized as Maryland corporations.

Several of the 1987 changes to the Maryland corporate statute apply specifically to investment companies registered under the 1940 Act. Md. Ann. Code §§ 2-105, -501 (1987). Under the amended law, the charter or bylaws of the corporation may provide that:

> the corporation may not be required to hold an annual meeting in any year in which none of the following is required to be acted on by stockholders under the Investment Company Act of 1940: 1) election of directors; 2) approval of the investment advisory agreement; 3) ratification of the selection of independent public accountants; and 4) approval of a distribution agreement.

Id. § 2-501.

Some ambiguities exist under the amended law. First, a distribution agreement does not require shareholder approval under the 1940 Act. However, a Rule 12b-1 Plan does require shareholder approval, and this may be what the draftsmen had in mind. Second, it is unclear whether a special meeting, an annual meeting or both may be required when one of the four matters is to be voted on by the shareholders.

The 1987 amendment also provides that the board of directors (rather than the

A Massachusetts business trust[6] is an association organized by the execution and delivery of a declaration of trust, under which the beneficial interest is divided into transferable units or shares.[7] The Massachusetts business trust is, in Massachusetts practice, a form of "voluntary association."[8] Unlike a corporation, which is a creature

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shareholders) of a corporation that is registered as an open-end company under the 1940 Act may increase or decrease the aggregate number of authorized shares of the corporation. *Id.* § 2-105. This authority exists unless a provision has been included in the charter of the corporation after July 1, 1987, prohibiting action by the board of directors to increase or decrease the number of authorized shares. *Id.* A corporation which increases its authorized shares must, however, make a filing and pay a filing fee, unlike a Massachusetts business trust.

6. As used in this article, the term "Massachusetts business trust" is limited to trusts to which Massachusetts law applies. Similar business trusts organized under the laws of other states are sometimes also referred to as "Massachusetts business trusts," but they are beyond the scope of this article.

If a draftsman chooses a Massachusetts business trust, the declaration of trust should include a choice-of-law provision which specifies that Massachusetts law be applied. Generally, case law indicates that courts in other jurisdictions as well as Massachusetts would recognize a choice-of-law provision under most circumstances. For example, in Hasan v. CleveTrust Realty Investors, 548 F. Supp. 1146 (N.D. Ohio 1982), *vacated on other grounds*, 729 F.2d 372 (6th Cir. 1984), an Ohio court held in a shareholder derivative action that Massachusetts law would apply to a Massachusetts business trust which had a Massachusetts choice-of-law provision in its declaration of trust. *Id.* at 1148. Courts in other jurisdictions have also applied Massachusetts choice-of-law provisions in actions involving internal affairs of the business trust. *See* Skolnik v. Rose, 55 N.Y.2d 964, 434 N.E.2d 251, 449 N.Y.S.2d 182 (1982); Greenspun v. Lindley, 36 N.Y.2d 473, 330 N.E.2d 79, 369 N.Y.S.2d 123 (1975).

As a separate basis for the application of Massachusetts law, Massachusetts lawyers usually arrange to have the trustees execute and deliver the declaration of trust in Massachusetts. Some practitioners take the view that it is sufficient for the last initial trustee, if there is more than one, executing the declaration of trust to be located in Massachusetts, while others require all initial trustees executing the declaration of trust to be present in the Commonwealth and to execute it there. Because a trust is actually created by the execution and delivery of the instrument by the trustees rather than by a state filing, the location of execution and delivery may be a deciding factor in the choice-of-law question if the court looks beyond the parties' choice.

7. MASS. GEN. LAWS ANN. ch. 182, § 1 (West 1987). Chapter 182 excludes trusts "established for the sole purpose of exercising the voting rights pertaining to corporate stock or other securities in accordance with the terms of a written instrument." *Id. See* Richardson v. Clarke, 372 Mass. 859, 861-62, 364 N.E.2d 804, 807 (1977). The court in *Richardson* held that business trusts possess attributes of corporations and, therefore, are distinguishable from traditional trusts. *See also* 16a W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 8230 (perm. ed. 1983).

8. A "voluntary association" is "an association of persons with a combined capital, represented by transferable shares, for the purpose of carrying on a common project for gain." *Report of the Massachusetts Tax Commissioner on Voluntary Associations*, Mass. House Rep. No. 1646, at 2 (1912) [hereinafter *1912 Report*].

of state statute,[9] a business trust is created by agreement.[10] Filing a declaration of trust with the Commonwealth of Massachusetts is not a condition precedent to the existence of the trust.[11] Indeed, if no filing of any kind is made, the trust entity will still exist, even though its trustees are in violation of Massachusetts law.[12] In contrast, a corporation will not exist unless the requisite documents are executed and filed with the appropriate state authority[13] because normally a corporation can be created only through statutory compliance.[14]

The recent popularity of a Massachusetts business trust as a vehicle for new open-end investment companies is founded primarily upon the flexibility of the vehicle as well as the simplicity and economy of its organization and operation. This article reviews the origins of the Massachusetts business trust, discusses the legal development of the relationships of the trustees and shareholders to the business trust, and summarizes the use of business trusts for investment companies.

II. HISTORY AND DEVELOPMENT OF THE MASSACHUSETTS BUSINESS TRUST

A. Origins in Great Britain and Massachusetts

In eighteenth century England, each corporation required authorization "either by act of Parliament, or by a charter from the Crown."[15] Due to the difficulty of obtaining Parliamentary authority

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9. 1a W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 113 (perm. ed. 1983).

10. *See, e.g.*, MASS. GEN. LAWS ANN. ch. 182, § 1 (West 1987).

11. *Id.* § 2 provides that "[t]he trustees of an association or trust shall file a copy of the written instrument or declaration of trust creating it with the secretary and with the clerk of every city or town where such association or trust has a usual place of business." *See* Gutelius v. Stanbon, 39 F.2d 621, 623-24 (D. Mass. 1929) (failure to record cannot deprive trustees of power conferred by trust).

12. Mass. Gen. Laws Ann. ch. 182, § 2 (West 1987) provides that "[t]he trustees of every association or trust, whose written instrument or declaration of trust creating it is not filed as required in this section shall be punished by a fine of not more than five hundred dollars or by imprisonment for not more than three months."

Other provisions of chapter 182 include: (1) a prohibition on the assumption of the name of another corporation or trust; (2) authority for individuals to sue a trust as a legal entity; (3) a requirement to file an annual report which shall state (a) the name of the trust; (b) the location of its principal office; (c) the number of its issued and outstanding shares; and (d) the names and addresses of its trustees.

13. *See* DEL. CODE ANN. tit. 8, § 103 (1987); RMBCA § 2.03 (1985).

14. *See* FLETCHER, *supra* note 9, § 166.

15. E. WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION 330 (1929) (quoting the Bubble Act).

or a Crown charter, many associations were voluntarily formed for the purpose of offering shares to the public without that proper authorization.[16] To eliminate this practice, the English Bubble Act was passed in 1719 to limit associations which "presumed to act as if they were corporate bodies, and have pretended to make their shares in stocks transferable or assignable, without any legal authority, either by act of Parliament, or by a charter from the Crown."[17] In enforcing the Bubble Act, nineteenth century English courts held that "transferable shares were illegal because members of the public were misled into supposing that if they assigned their shares they would get rid of all the liabilities attached to them."[18] Even some Massachusetts decisions during the nineteenth century discussed the Bubble Act because it was in force at the time of the American Revolution.[19] The Bubble Act was repealed by Parliament in 1825.[20]

One type of voluntary association, the investment trust, was found in Great Britain in the 1860's before the corporation laws were consolidated by the Companies Acts.[21] Investment trusts were professionally managed associations which held diversified assets to reduce investors' risks. It is reported that "the earliest of these associations were unincorporated, of a voluntary nature, and of a fiduciary character, and hence were called trusts in accordance with the custom of that time."[22] After Parliament enacted the Companies Acts, these trusts were required to register as "companies" but continued to keep the trust form.[23]

Although Massachusetts was a pioneer in America's industrial development, it was one of the last of the major states to permit

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16. *See 1912 Report*, *supra* note 8, at 2-4.

17. WARREN, *supra* note 15, at 330.

18. *Id.* at 331.

19. *See, e.g.*, Phillips v. Blatchford, 137 Mass. 510 (1884) (partnerships with transferable shares exist despite conflicting English statute).

20. WARREN, *supra* note 15, at 330 n.5 (6 Geo. 4, c.91 (1825)).

21. *See* L. ROBINSON, INVESTMENT TRUST ORGANIZATION AND MANAGEMENT 187-207 (1926); T. GRAYSON, INVESTMENT TRUSTS, THEIR ORIGIN, DEVELOPMENT AND OPERATION 1 (1928); *Investment Trusts in Great Britain, Report of the Securities and Exchange Commission Pursuant to Section 30 of the Public Utility Holding Company Act of 1935* (1939) [hereinafter *SEC Report on British Investment Trusts*]. The Securities and Exchange Commission (SEC) prepared an extensive report on British investment trusts before the passage of the 1940 Act.

22. *See* GRAYSON, *supra* note 21, at 1-2.

23. *See* The Companies Acts, 25 & 26 Vict. ch. 89, § 180 (1862) (companies capable of being registered).

incorporation without special legislative act.[24] Even after the adoption of a general incorporation statute in 1851, business trusts were attractive because they provided an alternative to corporations which could be organized only pursuant to the restrictive state corporate statute.[25] The nineteenth century statute: (1) prohibited dealing in real estate; (2) established minimum and maximum capital amounts; and (3) required corporations to file detailed annual statements of assets and liabilities.[26] Business trusts were not subject to the statute and its limitations and disclosure requirements.[27]

The statutory prohibition against a corporation's dealing in real estate is generally considered to be the major reason for the growth of business trusts.[28] Apparently the prohibition has its roots in the policy of the English mortmain statutes which were designed to end the ownership of large tracts of land by ecclesiastical bodies and the consequent removal of land from the tax rolls.[29] In one of the early Massachusetts cases regarding business trusts, *Williams v. Inhabitants of Milton*,[30] the Supreme Judicial Court held that a business trust

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24. *See* Dodd, *Statutory Developments in Business Corporation Law, 1886-1936*, 50 HARV. L. REV. 27, 31 (1936) (discussion of early Massachusetts corporation statutes).

25. *See* Mass. Pub. Stat. tit. XV, ch. 105, 106 (1882). *See also* FLETCHER, *supra* note 7, § 8227; Dodd, *supra* note 24, at 31-39.

26. Mass. Pub. Stat. tit. XV, ch. 106, § 14 (1882). *See also* Dodd, *supra* note 24, at 32.

27. *See* J. SEARS, TRUST ESTATES AS BUSINESS COMPANIES 357-61 (2d ed. 1921). Business trusts are described as entities with greater "flexibility" and "continuity" of management than corporations. Business trusts were considered to have more flexibility because trustees could "transact business with more ease and rapidity than directors" and more continuity because "trustees who are managing officers of a trust are not so likely to be changed as are the officers of a corporation." *Id.* at 360.

28. *See, e.g.*, FLETCHER, *supra* note 7, § 8231; Grayson, *supra* note 21, at 152; ROBINSON, *supra* note 21, at 20; SEARS, *supra* note 27, at 357-61. Sears discusses the *1912 Report*. *See supra* note 8. The *1912 Report* estimated that real estate trusts in Boston held property of $250 million. Sears also includes exhibits of declarations of trust for early trusts including The Wachusett Realty Trust (1912) and Boston Personal Property Trust (1895). SEARS, *supra* note 27, at 418-39.

29. *1912 Report*, *supra* note 8, at 14.

30. 215 Mass. 1, 102 N.E. 355 (1913). *See* Gleason v. McKay, 134 Mass. 419 (1883); Alvord v. Smith, 22 Mass. 232 (1827). Real estate business trusts are referred to in Attorney General v. Proprietors of the Meetinghouse, 69 Mass. 1 (1854), *writ of error dismissed*, 66 U.S. 262 (1861). Real estate business trusts may have developed from use of nominee trusts in real estate. In a nominee trust, trustees hold title to real property pursuant to a declaration of trust for the benefit of undisclosed beneficiaries. *See* Birnbaum & Monohan, *The Nominee Trust in Massachusetts Real Estate Practice*, 60 MASS. L.Q. 364 (1976). The first Massachusetts case which held that a voluntary association was a business trust rather than a partnership was Mayo v. Moritz, 151 Mass. 481, 24 N.E. 1083 (1890).

organized to deal in real estate should be taxed as a trust rather than a partnership or corporation.[31] Real estate trusts were also the focus of several other Massachusetts and federal cases dealing with business trusts.[32]

In late nineteenth and early twentieth century Massachusetts, the business trust was widely used for street railway and electric and gas utility companies.[33] This was a means of avoiding the statutory limitation on the amount of capital which such a utility could issue, and the uncertainty whether a corporation could own the controlling shares of other utilities.[34] Massachusetts business trusts could issue unlimited amounts of capital.[35] Also, where more than one utility was owned by a single entity the subsidiaries could enjoy more efficient management as part of a unified system, not otherwise achievable due to restrictions on the consolidation of utilities.[36] In the *Report of the Massachusetts Tax Commissioner on Voluntary Associations* (1912 Report) the Commissioner discussed the common use of "holding trusts" to acquire securities of public service corporations. He noted that Massachusetts courts recognized the legal status of these voluntary associations, and concluded:

> that [voluntary associations] should be prohibited would be an unwarranted interference with the right of contract, and would raise serious constitutional questions. My opinion is that since large amounts of capital have been put into these associations and they have already been recognized by law, it would be wise to subject them to further regulation by the State, especially such of them as own, hold or control stocks of public service corporations.[37]

As a result of the *1912 Report*, the Massachusetts legislature passed a bill in 1913 which provided that a *corporation* could not hold more

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31. Williams v. Inhabitants of Milton, 215 Mass. 1, 102 N.E. 355 (1913).

32. *See, e.g.*, Gutelius v. Stanbon, 39 F.2d 621 (D. Mass. 1929); State Street Trust Co. v. Hall, 311 Mass. 299, 41 N.E. 2d 30 (1942); Downey Co. v. Whistler, 284 Mass. 461, 188 N.E. 243 (1933). *See also* Hecht v. Malley, 265 U.S. 144 (1924); Crocker v. Malley, 249 U.S. 223 (1919).

33. *See generally 1912 Report, supra* note 8, at 21-23.

34. *Id.*

35. *See id.* at 23.

36. *1912 Report, supra* note 8, at 21-25.

37. *Id.* at 26.

than 10% of the shares of an operating utility company.[38] Significantly, the prohibition was not made applicable to voluntary associations.[39]

Many of the early investment companies were organized as Massachusetts business trusts rather than as corporations.[40] Massachusetts Investors Trust, a business trust organized in 1924, is considered to be the first open-end investment company.[41] Investment companies appear to have been organized as Massachusetts business trusts for several reasons. First, Massachusetts business trusts are entities similar to British investment trusts upon which the first American investment companies were modeled.[42] Second, investment companies have parallels to real estate trusts and utility holding companies, both of which were commonly organized as Massachusetts business trusts. In investment trusts, as in real estate trusts and utility holding companies, shareholders invest in a pool of assets to obtain profits from management of the assets by trustees, and the trusts themselves do not actively engage in a trade or business.[43]

B. Legal Development of Massachusetts Business Trusts

Since the time Massachusetts courts first recognized the business trust as a distinct form of organization, Massachusetts case law has

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38. MASS. GEN. LAWS ANN. ch. 156, § 5 (West 1987). The statute was initially passed in 1913. ch. 597 (1913). *See also* SEARS, *supra* note 27, at v-vii. Sears lists several utility trusts including Massachusetts Gas Companies (listed on the Boston Stock Exchange), North Boston Lighting Properties, Boston Suburban Electric Companies, Boston Electric Associates, and Massachusetts Lighting Companies. Sears also notes other types of business trusts including Amoskeag Manufacturing Company (listed on the Boston Stock Exchange). *Id. See also* Flynn v. Commissioner of Dep't of Pub. Utils., 302 Mass. 131, 18 N.E.2d 538 (1939) (court held that a Massachusetts business trust could hold the majority of shares of a utility and control it); Gardiner v. Gardiner, 212 Mass. 508, 99 N.E. 171 (1912) (court discusses shares of Massachusetts Electric Companies, a trust organized to acquire shares of street railway and other companies).

39. *Flynn*, 302 Mass. at 133, 18 N.E.2d at 540.

40. *See A Study of Mutual Funds—Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce* [hereinafter *Wharton Report*]. H.R. REP. No. 2274, 87th Cong., 2d Sess. 37 (1962); *Investment Trusts and Investment Companies*, Letter from SEC Chairman, H.R. Doc. No. 70., 76th Cong., 1st Sess. 28-29 (1939) [hereinafter *1939 SEC Letter*]; Grayson, *supra* note 21, at 152-60; Robinson, *supra* note 21, at 313-15.

41. *Wharton Report*, *supra* note 40, at 37.

42. *See generally SEC Report on British Investment Trusts*, *supra* note 21; Grayson, *supra* note 21, at 147 (Massachusetts business trusts were called "Anglo-American trusts" because they resemble the British form). That is, both forms are unincorporated, have trustees instead of directors, and have transferable shares of beneficial interest. *Id.*

43. *See* SEARS, *supra* note 27, at 13.

continued to provide a hospitable environment for the business trust.[44] The legal development of Massachusetts business trusts can be traced by reviewing the recognition of the business trust as a distinct legal entity, the relationship of trustees to the business trust and the relationship of shareholders to the business trust.

1. Recognition of the Business Trust as a Legal Entity

In 1885, in *Ricker v. American Loan & Trust Co.*,[45] a case involving the taxation of an association organized for the purpose of buying, selling and leasing railroad rolling stock, the Supreme Judicial Court of Massachusetts held that what currently would be regarded as a business trust was a partnership.[46] The court stated that "there is no intermediate form of organization between a corporation and a partnership."[47] In 1890, however, the Supreme Judicial Court established in *Mayo v. Moritz*[48] that a business trust was an entity separate from a partnership.[49] In *Mayo*, an inventor assigned his rights in an invention to trustees to hold, manage and dispose of pursuant to the terms of a declaration of trust.[50] The declaration of trust provided that the trustees would pay one half of the net income to the inventor and one half to holders of transferable "scrip certificates" or shares in the trust.[51] The trustees entered into a lease on behalf of the trust and the landlord sued the shareholders of the trust for the rent.[52] The Supreme Judicial Court held that the declaration of trust "does not have the effect to make the [shareholders] partners."[53] Rather, the shareholders were beneficiaries of the trust or "cestuis que trust, and [were] entitled to their share of the avails of the property when the same was sold."[54] The court determined that "the trustees contracted a debt to the plaintiff, they [were] liable for it personally, and an action at law may be maintained by him against them."[55]

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44. *See infra* notes 45-63 and accompanying text.
45. 140 Mass. 346, 5 N.E. 284 (1885).
46. *Id.* at 349, 5 N.E. at 286.
47. *Id.* at 348, 5 N.E. at 286 (shareholders had the right to elect and remove a board of managers of the trust).
48. 151 Mass. 481, 24 N.E. 1083 (1890).
49. *Id.* at 484, 24 N.E. at 1083.
50. *Id.* at 482, 24 N.E. at 1083.
51. *Id.*
52. *Id.* at 484, 24 N.E. at 1083.
53. *Id.*
54. *Id.*
55. *Id.*

In its opinion, neither the *Ricker* decision nor the policy reasons for its holding were discussed by the court.[56]

The business trust was treated as a separate entity in the 1913 case of *Williams v. Inhabitants of Milton*.[57] In *Williams*, the court confronted the issue of whether Boston Personal Property Trust, a real estate trust organized in 1893, should be taxed as a trust or a partnership.[58] The declaration of trust of Boston Personal Property Trust provided that the trustees had the power to: (1) issue transferable shares of beneficial interest in the trust; (2) hold the trust funds and property for the benefit of shareholders; (3) invest the trust funds in real estate, including bonds and notes on real estate; (4) improve and lease real estate; and (5) borrow money.[59] The shareholders of the trust had the right to: (1) have the property administered by the trustees; (2) receive income from the trust; (3) approve a change in the declaration of trust or termination of the trust; and (4) receive their share of the trust at termination.[60] The declaration of trust did not give shareholders the right to hold annual meetings or to elect trustees.[61] The court held that the entity established was a business trust rather than a partnership because the declaration of trust made the trustees "masters" of the trust property.[62] The court distinguished earlier cases where shareholders acted as principals and controlled trustees who acted merely as agents.[63]

Notwithstanding *Mayo* and *Williams*, neither the Massachusetts business trust statute nor the courts recognize the business trust as a legal entity for all purposes.[64] In fact, in 1933, the Supreme Judicial Court of Massachusetts in *Larson v. Sylvester*[65] described the nature of a business trust as follows:

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56. *Id.*

57. 215 Mass. 1, 102 N.E. 355 (1913).

58. *Id.* at 10, 102 N.E. at 358.

59. *Id.* at 2-5, 102 N.E. at 355 (declaration of trust language is included in state reporter only).

60. *Id.*

61. *Id.*

62. *Id.* at 8, 102 N.E. at 358.

63. *Id.* at 8-9, 102 N.E. at 358. *See* Williams v. Boston, 208 Mass. 497, 94 N.E. 808 (1911); Ricker v. American Loan & Trust Co., 140 Mass. 346, 5 N.E. 284 (1885); Phillips v. Blatchford, 137 Mass. 570 (1884); Whitman v. Porter, 107 Mass. 522 (1871); Hoadley v. County Comm'rs, 105 Mass. 519 (1870).

64. Williams v. Inhabitants of Milton, 215 Mass. 1, 102 N.E. 355 (1913); Mayo v. Moritz, 151 Mass. 481, 24 N.E. 1083 (1890).

65. 282 Mass. 352, 185 N.E. 44 (1933).

> Speaking generally a trust is not a legal personality. With the exception later to be dealt with, it cannot be sued. . . . It differs from a corporation or a partnership. The former is a legal person. The latter, in the law of Massachusetts, is an association of individuals united for transaction of business. The former can be sued as a body corporate in its own name. The latter must be sued, ordinarily, in the names of the partners.[66]

The court held, however, that the plaintiff in *Larson* could sue the business trust under a section of the Massachusetts business trust statute[67] stating that:

> An association or trust may be sued in an action at law for debts and other obligations or liabilities contracted or incurred by the trustees, or by the duly authorized agents of such trustees, or by any duly authorized officer of the association or trust, in the performance of their respective duties under such written instruments or declarations of trust, and for any damages to persons or property resulting from the negligence of any trustees, agents or officers acting in the performance of their respective duties, and its property shall be subject to attachment and execution in like manner as if it were a corporation, and service of process upon one of the trustees shall be sufficient.[68]

Other states recognize business trusts as distinct entities for tax and other purposes.[69] For example, Minnesota provides that a Minnesota

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66. *Id.* at 357-58, 185 N.E. at 45-46.

67. *Id.* at 358-59, 185 N.E. at 46. The *Larson* action was brought to secure property of the defendant, Sylvester, which was not attachable at law, and to apply it to satisfy a claim for labor and materials. *Id.* at 353, 185 N.E. at 44. Sylvester had contracted the work as trustee of the Winchester Building Trust, a trust established under a written declaration. *Id.* The issue was whether the trustee could be personally liable for the labor and materials furnished by the plaintiff to the trust, (1) where there was no stipulation between the parties that the defendant would be personally liable, (2) where the plaintiff knew the defendant acted merely as trustee, and (3) where the plaintiff could have sued the trust entity at law. *Id.*

68. MASS. GEN. LAWS ANN. ch. 182, § 6 (West 1933); *Larson*, 282 Mass. at 358-59, 185 N.E. at 46.

69. Several other states have business trust statutes. ALA. CODE §§ 19-3-60 to -3-67 (1987); ARIZ. REV. STAT. ANN. §§ 10-501 to -509 (1987); FLA. STAT. § 609.01-.08 (1987); IND. CODE §§ 23-5-1-1 to -1-11 (1987); KAN. STAT. ANN. §§ 17-2027 to -2038 (1987); KY. REV. STAT. ANN. §§ 386.370-.440 (Baldwin 1987); MINN. STAT.

business trust shall be a "separate unincorporated legal entity, not a partnership, joint stock association, agency or any other relation except a business trust."[70] The Minnesota law also states that a business trust shall have the power "to sue and be sued."[71]

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§§ 318.01-.06 (1987); MISS. CODE ANN. §§ 79-15-1 to -15-29 (1987); MONT. CODE ANN. §§ 35-5-101 to -5-205 (1987); N.Y. GENERAL ASSOCIATIONS LAW § 1-21 (McKinney 1987); N.C. GEN. STAT. §§ 39-44 to -47 (1987); OHIO REV. CODE ANN. §§ 1746.01 to .99 (Baldwin 1987); OR. REV. STAT. §§ 128.560 to .595 (1987); S.C. CODE ANN. §§ 33-53-10 to -53-50 (Law. Co-op. 1987); S.D. CODIFIED LAWS ANN. §§ 47-14-1 to -14-13 (1987); TENN. CODE ANN. § 48-14-101 (1987); WASH. REV. CODE § 23.90.010-.040 (1987); W. VA. CODE §§ 47-9A-1 to -9A-6 (1987); WIS. STAT. § 226.14 (1987).

The Minnesota statute, which was originally enacted in 1961, provides that two or more persons may organize and associate for the purpose of transacting business under a declaration of trust. MINN. STAT. § 318.01 (1987). The statute requires a business trust to file a copy of the declaration of trust prior to transacting business in the state. *Id.* § 318.02. In addition, the Minnesota law states that any association so organized "shall be a business trust and a separate unincorporated legal entity, not a partnership . . . or any other relation except a business trust." *Id.* A Minnesota business trust has statutory powers to: (1) continue in existence as a business trust for the time specified in its declaration of trust, or if not stated, perpetually; (2) sue and be sued; (3) adopt a seal; (4) conduct business, contract, and do any acts necessary and incidental to purposes stated in the declaration of trust; and (5) acquire, or deal in and dispose of real and personal property by or through officers, agents or trustees. *Id.* Also, unlike the Massachusetts business trust statute, the Minnesota statute provides limited liability to shareholders and trustees:

> No personal liability for any debt or obligation of any such association heretofore or hereafter organized shall attach to the owners of the shares of beneficial interests, beneficiaries, shareholders, or trustees of any such association heretofore or hereafter organized, or to any person or party to the "declaration of trust."

Id. Like the Massachusetts statute, the Minnesota statute does not require an annual meeting of shareholders, nor does it provide for indemnification of trustees of the trust. In addition, in 1987 Minnesota amended its income tax provisions to provide that an investment company registered under the 1940 Act transacting business in the state shall report the net income as calculated under the provisions of the Internal Revenue Code, less credits and adjustments under Minnesota law. MINN. STAT. § 290.36 (1987).

70. MINN. STAT. § 318.02 subdiv. 2 (1987). The subdivision provides:

> [A]ny such association heretofore or hereafter organized shall be a business trust and a separate unincorporated legal entity, not a partnership, joint-stock association, agency, or any other relation except a business trust. A business trust is also known as a common law trust and Massachusetts trust for doing business.

Id.

71. *Id.* at subdiv. 3.

2. Relationship of the Trustees to the Business Trust

Considered the embodiment of the Massachusetts business trust, the trustees occupy a position of particular importance in those organizations.[72] Massachusetts courts have said that the trust "property is the property of the trustees and the trustees are the masters."[73] Conversely, a corporation:

> is a legal personality which may act through agents. A contract made by the authorized agent of a corporation is the corporation's contract. A trust . . . can itself do no act. It cannot make a contract. It cannot even act to choose an agent. The trustee alone can do any act which affects the rights or property of the trust. He does not act as the agent of the trust but is its embodiment in dealing with its property and in making contracts which affect its property. Such contracts when made are his contracts and he is personally liable upon them unless they include an agreement that he shall not be personally liable.[74]

Trustees may act by majority if the declaration of trust so provides; however, all trustees must be consulted and participate in the administration of the business trust.[75] It is also well established that the trustees (as opposed to the "trust") may act through officers and agents.[76]

Unlike the directors of corporations in many states, the trustees of a Massachusetts business trust do not enjoy the benefit of statutory limitation of liability or indemnification provisions.[77] Massachusetts courts, however, recognize that a trustee's liability may be limited if a statement to that effect is included in a declaration of trust, providing that a person contracting with a trustee agrees to look only to the assets of the trust for satisfaction of the contract.[78] For example, in

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72. Dolben v. Gleason, 292 Mass. 511, 514, 198 N.E. 762, 763 (1935).

73. Williams v. Inhabitants of Milton, 215 Mass. 1, 8, 102 N.E. 355, 357 (1913).

74. *Dolben*, 292 Mass. at 514-15, 198 N.E. at 763.

75. Richardson v. Clarke, 372 Mass. 859, 863, 364 N.E.2d 804, 807 (1977).

76. McCarthy v. Parker, 243 Mass. 465, 138 N.E. 8 (1923).

77. The Massachusetts statutory provisions which apply to business trusts do not include limited liability for directors. MASS. GEN. LAWS ANN. ch. 182 (1987). Many corporation statutes, however, do include such provisions. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141(e) and 145 (1987).

78. Dolben v. Gleason, 292 Mass. 511, 198 N.E. 762 (1935).

Dolben v. Gleason,[79] the declaration of trust provided that any person contracting with the trustee should look only to the trust property for payment of the contract, and not to the trustee or shareholders personally.[80] The declaration also stated that in any written contract or undertaking by a trustee, reference should be made to the declaration.[81] The court noted as a general rule that "in the absence of a stipulation to the contrary a trustee is personally liable in an action on a contract made by him for the benefit of the trust estate."[82] The court added that a trustee "may, however, avoid personal liability on a contract he makes on behalf of the trust, if the contract contains an agreement that he shall not be personally liable."[83] Hence, a collateral agreement is needed to bind the third party to any exculpatory language in a declaration of trust.[84]

A trustee of a business trust is protected from liability in other ways as well. First, Massachusetts law provides that persons may bring a direct action against the trust property rather than the trustees.[85] Second, a well-drafted declaration of trust should provide that a trustee is not personally liable for the obligations of the trust, and that he is to be indemnified out of the assets of the trust if he does become so liable. Third, even where these provisions are not included in the declaration of trust, Massachusetts courts recognize an equitable right of trustees "to reimbursement from the trust assets for obligations incurred for the benefit of the trust . . . ."[86] Finally, although it is unclear whether the following provision applies to trustees of a business

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79. *Id.*

80. *Id.* at 512, 198 N.E. at 763. In *Dolben*, plaintiff delivered building materials to defendant. Defendant had endorsed the delivery contract with the words "accepted 12/27/32 Lakemoor Trust H.O. Gleason Trust." When the defendant failed to pay for the materials, plaintiff sued. The appellate court affirmed the trial court's ruling for plaintiff.

81. *Id.*

82. *Id.* at 513, 198 N.E. at 763.

83. *Id.* at 514, 198 N.E. at 763.

84. *Id.* at 513, 198 N.E. at 763.

85. MASS GEN. LAWS ANN. ch. 182, § 6 (1987) provides in relevant part:

> An association or Trust may be sued in an action at law for debts and other obligations or liabilities contracted or incurred by the trustees . . . in the performance of their respective duties under such written instructions or declarations of Trust . . . and its property shall be subject to attachment and execution in the like manner as if it were a corporation . . . .

86. Town of Hull v. Tong, 14 Mass. App. 710, 712, 442 N.E.2d 427, 429 (1982) (citing Downey Co. v. 282 Beacon Street Trust, 292 Mass. 175, 178, 197 N.E. 643 (1935)).

trust or whether it applies only to trustees of a traditional testamentary or intervivos trust,[87] trustees may be protected from personal liability on contracts under a 1976 amendment[88] to chapter 203, the general Massachusetts trust statute.[89] Section 14A of chapter 203 states that:

> [u]nless otherwise provided in the contract, a trustee shall not be personally liable on contracts properly entered into in his fiduciary capacity in the course of administration of the trust estate unless he failed to reveal his representative capacity and identify the trust estate in the contract.
>
> A trustee shall be personally liable for obligations arising from ownership or control of property of the trust estate or for torts committed in the course of administration of the trust estate only if he was personally at fault.[90]

The debate whether, under state law, a trustee of a registered investment company in trust form is held to a higher standard of care or is less able to be indemnified than a director of such a company in corporate form is probably, as a practical matter, rendered moot by the provisions of the 1940 Act. Section 17(h) of the 1940 Act provides a minimum standard of care for both directors and trustees.[91] Other sections and rules under the 1940 Act place specific

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87. Richardson v. Clarke, 372 Mass. 859, 364 N.E.2d 804 (1977) ("Business trusts have many of the attributes of corporations and for that reason cannot be governed solely by the rules which have evolved for traditional trusts."). *Compare* H. HENN & J. ALEXANDER, THE LAW OF CORPORATIONS § 58 (1983) (law of trusts governs cases involving business trusts) *with* RESTATEMENT (SECOND) OF TRUSTS § 1, comment 10 (1959) (express exclusion of business trusts from scope of coverage).

88. 1976 Mass. Act. c. 515, § 28.

89. MASS. GEN. LAWS ANN. ch. 203, §14A (1987) (chapter 203 deals with trusts in general).

90. *Id.* The provision goes on to state that:

> [c]laims based on contracts entered into by a trustee in his individual capacity, on obligations arising from ownership or control of the trust estate, or on torts committed in the course of trust administration may be asserted against the trust estate by proceeding against the trustee in his fiduciary capacity, whether or not the trustee was personally liable therefor.
>
> The question of liability as between the trust estate and the trustee individually may be determined in an accounting, surcharge, indemnification or other appropriate proceeding.

91. 15 U.S.C. § 80a-17(h) (1987) provides:

> [N]either the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws [sic] of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or

duties on the directors or trustees (or sometimes those directors or trustees of the investment company who are not "interested persons") to: approve investment advisory and principal underwriting contracts,[92] Rule 12b-1 plans (which authorize open-end investment companies to pay distribution costs out of company assets),[93] the use of

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purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

The term "director" includes a trustee of a business trust. *See infra* note 183.

92. 15 U.S.C. § 80a-15(a) (1987), provides in relevant part:

(a) It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and—

. . . .

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company . . .;

. . . .

(b) It shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract—

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors . . . .

93. Rule 12b-1(b)(2), 17 C.F.R. 270.12b-1. Rule 12b-1 was adopted pursuant to Investment Company Act Release No. IC-11414, Fed. Sec. L. Rep. (CCH) ¶ 82,678 (Oct. 28, 1980), which provides in relevant part:

(b) A registered, open-end management investment company ("company") may act as a distributor of securities of which it is the issuer: *Provided*, That any payments made by such company in connection with such distribution are made pursuant to a written plan describing all material aspects of the proposed financing of distribution and that all agreements with any person relating to implementation of the plan are in writing: *And further provided*, that:

. . . .

(2) Such plan, together with any related agreements, has been approved by a vote of the board of directors of such company, and of the directors who are not interested persons of the company and have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan . . . .

securities depositories,[94] foreign custody arrangements[95] and fidelity bonds;[96] select auditors;[97] fix the time of determining net asset

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94. Rule 17f-4(c), 17 C.F.R. § 270.17f-4(c). Rule 17f-4, adopted pursuant to Investment Company Act Release No. IC-14132, Fed. Sec. L. Rep. (CCH) ¶ 81,753 (1978), provides in relevant part:

> (c) An investment company may deposit the securities in a clearing agency which acts as a securities depository under an arrangement that contains the following elements: . . . .
>
> (3) The investment company, by resolution of its board of directors, approved the arrangement, and it is reviewed at least annually.

95. Rule 17f-5(a)(1), 17 C.F.R. 270.17f-5(a)(1). Rule 17f-5 adopted pursuant to Investment Company Act Release No. IC-14132, Fed. Sec. L. Rep. (CCH) ¶ 83,655 (1984), provides in relevant part:

> (a) Any management investment company registered under the Act, and incorporated or organized under the laws of the United States or of a state, may place and maintain in the care of an eligible foreign custodian the company's foreign securities, cash and cash equivalents in amounts reasonably necessary to effect the company's foreign securities transactions, *Provided*, That:
>
> (1) A majority of the board of directors of the company shall have:
>
> (i) Determined that maintaining the company's assets in a particular country or countries is consistent with the best interests of the company and its shareholders;
>
> (ii) Determined that maintaining the company's assets with a particular foreign custodian is consistent with the best interests of the company and its shareholders; and
>
> (iii) Approved, as consistent with the best interests of the company and its shareholders, a written contract which will govern the manner in which such custodian will maintain the company's assets . . . .

96. Rule 17g-1(d), 17 C.F.R. 270.17g-1(d). Rule 17g-1, adopted pursuant to Investment Company Act Release No. IC-1112 (1947), provides in relevant part:

> (d) The bond shall be in such reasonable form and amount as a majority of the board of directors of the registered management investment company who are not "interested persons" of such investment company . . . shall approve as often as their fiduciary duties require, but not less than once every twelve months, with due consideration to all relevant factors including, but not limited to, the value of the aggregate assets of the registered management investment company to which any covered person may have access, the type and terms of the arrangements made for the custody and safekeeping of such assets, and the nature of the securities in the company's portfolio . . . .

97. 15 U.S.C. § 80a-31(a)(1) (1987).

> § 80a-31. Accountants and auditors
>
> (a) Selection of accountant
>
> It shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless—
>
> (1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a

value;[98] value portfolio securities for which market quotations are not readily available;[99] and approve portfolio transactions with certain affiliated investment companies.[100]

In various releases, the Securities and Exchange Commission (SEC) has expressed its views on how a board should discharge its

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majority of those members of the board of directors who are not interested persons of such registered company . . . .

98. Rule 22c-1(b)(1), 17 C.F.R. 270.22c-1(b)(1). Rule 22c-1 adopted pursuant to Investment Company Act Release No. IC-5519, Fed. Sec. L. Rep. (CCH) ¶ 77,616 (1969), provides in relevant part:

> (b) For the purposes of this section, (1) the current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day that the board of directors of the investment company sets at least annually, except on (i) days on which changes in the value of the investment company's portfolio securities will not materially affect the current net asset value of the investment company's redeemable securities, (ii) days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company, or (iii) customary national business holidays described or listed in the prospectus and local and regional business holidays listed in the prospectus; and (2) a "qualified evaluator" shall mean any evaluator which represents it is in a position to determine, on the basis of an informal evaluation of the eligible trust securities held in the Trust's portfolio . . . .

99. 15 U.S.C. § 80a-2(41)(A)(ii), which provides in relevant part:

> "Value", with respect to assets of registered investment companies, except as provided in subsection (b) of section 80a-28 of this title, means—
> (A) . . . (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, fair value at the end of such quarter, as determined in good faith by the board of directors . . . .

100. Rule 17a-7(e), 17 C.F.R. 270.17a-7(e). Rule 17a-7, adopted pursuant to Investment Company Act Release No. IC-11053, Fed. Sec. L. Rep. (CCH) ¶ 82,452 (1980), provides in relevant part:

> Exemption of certain purchase or sale transactions between an investment company and certain affiliated persons thereof.
> A purchase or sale transaction between registered investment companies or separate series of registered investment companies . . . is exempt from section 17(a) of the Act; *Provided*, That:
> . . . .
> (e) The board of directors of the investment company, including a majority of the directors who are not interested persons of such investment company, (1) adopts procedures pursuant to which such purchase or sale transactions may be effected for the company, which are reasonably designed to provide that all of the conditions of this section in paragraphs (a) through (d) have been complied with, (2) reviews no less frequently than annually such procedures for their continuing appropriateness, and (3) determines no less frequently than quarterly that all such purchases or sales made during the preceding quarter were effected in compliance with such procedures . . .

duties in these areas.[101] The SEC and its staff have also declared what a board's duties are in other areas which are not expressly provided for in the statute or the rules, such as the evaluation of repurchase agreements.[102] The authors believe that most attempts to hold either directors or trustees of an investment company liable would involve actions governed by the 1940 Act, the rules thereunder or matters relating to the duties of the board on which the Commission or the SEC staff has expressed its views.[103] Whatever the applicable state law standard of care,[104] the conduct of investment company trustees or directors will probably be evaluated in light of specific federally promulgated duties.

3. Relationship of Shareholders to a Business Trust

The shareholders of a business trust hold shares or units representing the beneficial interest in the trust property.[105] Accordingly, the shareholders have "a right to have the property managed by the trustees for their benefit. They [have] no right to manage it by themselves nor to instruct the trustees how to manage it for them."[106] The sole right of shareholders "is to have the property administered in their interest by the trustees, who are the masters, to receive income while the trust lasts, and their share of the corpus when the trust comes to an end."[107]

If shareholders of a business trust exercise control over the trustees, Massachusetts courts have held that a partnership rather

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101. *See, e.g.*, Investment Company Act Release No. IC-11414 and Investment Company Act Release No. IC-14132, *supra* notes 93 and 94.

102. *See* Investment Company Act Release No. IC-13005, Fed. Sec. L. Rep. (CCH) ¶ 48,528 (1983). Repurchase agreements are transactions in which an investment company purchases a security and simultaneously agrees to resell that security to the seller.

103. *See generally* 1 L. LOSS, SECURITIES REGULATION 144-53 (2d ed. 1961). *See also* Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181 (1966).

104. Under state corporate law, the standard of care of officers and a board of directors is usually formulated in terms of gross negligence or negligence. *See, e.g.*, Hanson Trust Plc v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986) (under New York law, the standard is negligence); Aronson v. Lewis, 473 A.2d 805, (Del. 1984) (gross negligence).

105. *See* G. BOGERT, TRUSTS & TRUSTEES § 247 (rev. ed. 1977); H. HENN & L. ALEXANDER, LAW OF CORPORATIONS § 59 (3d ed. 1983).

106. Williams v. Inhabitants of Milton, 215 Mass. 1, 8, 102 N.E. 355, 357 (1913) (citing Mayo v. Moritz, 151 Mass. 481, 484, 24 N.E. 1083 (1890)).

107. *Id.* at 11, 102 N.E. at 358.

than a business trust has been created.[108] A determination that an organization is a partnership may render the shareholders personally liable, as general partners, for the obligations of the organization.[109] The early decisions held that one of the elements of control which resulted in the creation of a partnership was the right to elect trustees.[110] The first Massachusetts case to recognize that the election of trustees by shareholders did not result in a partnership was *Commissioner of Corporations and Taxation v. City of Springfield.*[111] In *Springfield*, the Massachusetts Supreme Judicial Court considered whether Western Massachusetts Companies, a holding company which was the sole stockholder of two operating utility companies, was a business trust rather than a partnership for tax purposes.[112] The court compared the powers of the trustees and the shareholders as follows:

> The declaration of trust by which it was formed vested the legal title to all its property, with some exceptions not now material, in the trustees who were to manage and control its affairs. The trustees were authorized to acquire securities of gas and electric companies organized under the laws of this Commonwealth, to sell the whole or any part of the trust estate as they might in their uncontrolled discretion determine, and to appoint the officers and employees and fix their compensation. The holders of the transferable certificates or shares were to meet annually to elect trustees, the number of which might be increased but not decreased below nine persons, and to vote upon the issuance of shares, but they were to have no power to control the actions of the trustees and were not to be held liable for any act of the trustees, officers, agents or representatives of the association. The declaration and payment of dividends rested in the discretion of the trustees. The trust was not to ter-

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108. Frost v. Thompson, 219 Mass. 360, 106 N.E. 1009 (1914).

109. *Id.* at 364, 106 N.E. at 1010. *See* Uniform Partnership Act § 15 (1914) (partner liability).

110. *See, e.g.*, Ricker v. American Loan & Trust Co., 140 Mass. 346, 5 N.E. 284 (1885); Hoadley v. County Comm'rs, 105 Mass. 519 (1870).

111. 321 Mass. 31, 71 N.E. 2d 593 (1947). Earlier, the federal district court for Massachusetts held that a declaration of trust which empowered shareholders to hold annual meetings to elect trustees, but gave them no power to remove trustees or amend the declaration, created a business trust rather than a partnership. Gutelius v. Stanbon, 39 F.2d 621, 625 (1929), *on rehearing* (D. Mass. 1930).

112. *Springfield*, 321 Mass. at 39, 71 N.E.2d at 598.

> minate by the death of a trustee or shareholder, but the trust was to continue for seventy-five years unless sooner terminated by the vote of two thirds of the outstanding shares. No shareholder was to have any interest in the specific property of the trust estate or any right to a division or partition thereof. The indenture created a trust and not a partnership.[113]

The potential for shareholder liability continues to be an issue which must be addressed by lawyers representing Massachusetts business trusts. The 1962 prospectus of a real estate investment trust contains the following disclosure:

> The Declaration of Trust provides that shareholders shall not be subject to any personal liability for the acts or obligations of the Trust and that every written undertaking made by the Trust shall contain a provision that such undertaking is not binding upon any of the shareholders personally. Counsel for the Trust is of the opinion that no personal liability will attach to the shareholders under any undertaking containing such provision, except possibly in the few jurisdictions which decline to recognize a business trust as a valid organization of any kind. With respect to all types of claims in the latter jurisdictions and with respect to tort claims, contract claims where the provision referred to is omitted from the undertaking, claims for taxes and certain statutory liabilities in those jurisdictions which treat such a business trust as a partnership, the shareholders may be held personally liable in the event that claims are not satisfied by the Trust. However, the Declaration of Trust provides that in any such contingency the shareholder will be entitled to reimbursement from the general assets of the Trust. The Trust intends to carry insurance which the Trustees consider adequate to cover any foreseeable tort claims.[114]

Currently, investment company disclosure is very similar to the real estate investment trust language quoted above from a prospectus written a quarter century ago. There are changes, however, reflecting

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113. *Id.* at 39-40, 71 N.E.2d at 598.

114. The prospectus of Continental Mortgage Investors, dated March 21, 1962, at 4.

an increased familiarity and level of comfort with the Massachusetts business trust. The most striking change is that the prospectus,[115] which is the principal of two disclosure documents in a registration statement filed under the Securities Act of 1933 and the 1940 Act, merely states that the investment company was organized as a Massachusetts business trust. The statement of additional information (SAI), the second disclosure document, is where the possibility of shareholder liability is discussed.[116] The SAI, although customarily

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115. Under the Securities Act of 1933, "[t]he term prospectus means any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ." 15 U.S.C. § 77b(10) (1982). Section 5 of the Securities Act of 1933 provides:

> (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.
> (b) It shall be unlawful for any person, directly or indirectly—
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; and
> (2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.
> (c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

116. *See, e.g.*, the prospectus of Scudder Growth and Income Fund dated May 2, 1988 at 9 and Statement of Additional Information of Scudder Growth and Income Fund dated May 2, 1988 at B-44. The current Statement of Additional Information includes the following disclosure:

> The Fund is an organization of the type commonly known as a "Massachusetts business trust". Under Massachusetts law, shareholders of such a trust may, under certain circumstances, be held personally liable as partners for the obligations of the Fund. The Declaration of Trust contains an express disclaimer of shareholder liability in connection with the Fund

incorporated by reference into the prospectus, is given to investors only on request.[117] If the possibility of shareholder liability were believed to be greater than remote, the SAI disclosure would probably appear in the prospectus to avoid misleading by omission.[118] Indeed, investment companies have been organized as business trusts for over sixty years, and the authors have no knowledge of a plaintiff successfully holding a shareholder personally liable for the obligations of the trust.

Inclusion in contracts of a provision limiting liability to the assets of the trust is another response to the shareholder liability issue.[119] It is also common for such a provision to be printed on the stationery of a Massachusetts business trust.[120]

The Massachusetts courts have recognized the shareholders' power to bring a derivative action[121] and to vote by

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property or the acts, obligations or affairs of the Fund. The Declaration of Trust also provides for indemnification out of the Fund property of any shareholder held personally liable for the claims and liabilities to which a shareholder may become subject by reason of being or having been a shareholder. Thus, the risk of a shareholder incurring financial loss on account of shareholder liability is limited to circumstances in which the Fund itself would be unable to meet its obligations.

117. *See, e.g.*, the prospectus of Scudder Growth and Income Fund dated May 2, 1988, and Statement of Additional Information of Scudder Growth and Income Fund dated May 2, 1988.

118. The general instructions of Form N-1A, the registration statement of open-end investment companies, provides "the purpose of the prospectus is to provide essential information about the registrant in a way that will assist investors in making informed decisions about whether to purchase the securities being offered," while the statement of additional information is "designed to elicit additional information about registrants that the Commission has concluded is not necessary or appropriate in the public interest or for the protection of investors to require in the prospectus, but which may be of interest to at least some investors." Form N-1A.

119. *See* BOGERT, *supra* note 105, § 247 & n. 60; HENN & ALEXANDER, *supra* note 105, § 63.

120. For example, the following disclaimer on the stationery of an investment company organized as a business trust with separate series attempts to limit recovery to the assets of a particular series since there are no assets belonging to the trust generally:

[Company name omitted] is a Massachusetts business trust that issues shares in one or more series. All persons dealing with the Trust must look solely to the property of the applicable series of the Trust for the enforcement of any claims against it. No Trustee, officer, employee, agent or shareholder of the Trust assumes any personal liability in connection with its business or any personal liability for obligations entered into on its behalf.

121. Peterson v. Hopson, 306 Mass. 597, 612, 29 N.E.2d 140, 149 (1940). A derivative suit is an action brought on behalf of a corporation by a shareholder to

proxy.[122] In *Peterson v. Hopson*,[123] shareholders of a business trust brought an action against the trustees for diversion of profits from the trust property.[124] The court held that shareholders of the business trust could bring an action against the trustees to "restore" trust property.[125] The court stated that a current shareholder "has a right to participate in all assets of the trust including assets diverted from the trust before he obtained his shares and now to be restored."[126] In *Tracy v. Curtis*,[127] the court recognized a shareholder derivative action in a case where the trustees had misappropriated opportunities of the trust for themselves.[128]

In *Comstock v. Dewey*,[129] the court considered an action by shareholders to oppose shareholder voting by proxy in the election of trustees.[130] The court noted both that a provision in the declaration of trust authorized voting by proxy and that the custom of voting by proxy had existed for many years.[131] The court held that shareholders of the trust could vote by proxy because "there is nothing contrary to public policy for the owners of shares to authorize one to vote the shares at a meeting of the shareholders."[132]

Early business trusts were considered subject to the Rule Against Perpetuities which provides that an interest in a trust is invalid unless the interest vests not later than twenty-one years after the expiration of all lives in being at the creation of the trust.[133] The authors believe, however, that, since 1899, when the Supreme Judicial Court decided *Howe v. Morse*,[134] a Massachusetts business trust is not subject to the Rule Against Perpetuities. In *Howe*, a building association provided

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redress a wrong to the corporation when the corporation itself has refused to bring the action. *See generally* R. CLARK, CORPORATE LAW 396 (1986).

122. Comstock v. Dewey, 323 Mass. 583, 588, 83 N.E.2d 257, 259 (1949).

123. Peterson v. Hopson, 306 Mass. 597, 29 N.E.2d 140 (1940).

124. *Id.* at 607, 29 N.E.2d at 147.

125. *Id.* at 612-13, 29 N.E.2d at 150.

126. *Id.*

127. 10 Mass. App. 10, 405 N.E.2d 656 (1980), *aff'd*, 16 Mass. App. 910, 449 N.E.2d 701, *reh'g denied*, 398 Mass. 1105, 452 N.E.2d 1158 (1983).

128. *Id.* at 10, 405 N.E.2d at 661. The appeals court reversed the trial court's dismissal of plaintiff's derivative complaint and remanded for further findings stating, "[We] detect a distinct likelihood that defendants have derived some measure of personal profit arising out of wrongful management of the affairs of the trust." *Id.*

129. 323 Mass. 583, 83 N.E.2d 257 (1949).

130. *Id.* at 585, 83 N.E.2d at 258.

131. *Id.* at 587, 83 N.E.2d at 259.

132. *Id.* at 588, 83 N.E.2d at 259.

133. *See, e.g.*, Winsor v. Mills, 157 Mass. 362, 32 N.E. 352 (1892).

134. Howe v. Morse, 174 Mass. 491, 55 N.E. 213 (1899).

in its declaration of trust that the trust would continue until terminated by a vote of three-quarters of the shareholders.[135] The court held that the trust was not "void as creating a perpetuity."[136] The Massachusetts bar was slow in accepting the holding of *Howe*. It was common even after *Howe* for a declaration of trust to state that the trust would expire not more than twenty-one years after the death of the last survivor of a named list of individuals, unless terminated earlier by the shareholders.[137] The modern day declaration of trust, however, generally states that the business trust will continue indefinitely, unless terminated earlier by the trustees or shareholders.[138]

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135. *Id.* at 503, 55 N.E. at 213.

136. *Id.* at 503-04, 55 N.E. 214. The court in *Howe* reasoned as follows:

> Such a trust for the convenience of an unincorporated association in renting and selling land, under which the land is held for no other purpose, and where the income is not accumulated but is distributed as it accrues, and where the land is to be sold free of trusts at the will of the association, and where the whole equitable interest in the trust is at every moment vested absolutely in those who at that moment are shareholders, and never can become vested in any other persons save by act of the absolute owners or by operation of law upon their property, and not by force of any limitation contained in the deed of trust, the equitable interests so vested being also constantly vendible by their several owners without let or hindrance, as well as subject to their debts and passing like other property upon death by virtue not of the deed of trust but of the general laws governing the disposition of the property of decedents, withdraws no property from commerce, and is not within the reason or the terms of what is called the rule against perpetuities.

Id. at 503-04, 55 N.E. at 214.

137. For example, § 35 of the Declaration of Trust dated April 2, 1928, of Eastern Utilities Associates, a public utility holding company whose shares are listed on the New York Stock Exchange, provides that:

> [u]nless sooner terminated . . . , the trust hereby created shall continue in such manner that the Trustees shall have all the powers and discretions expressed to be given to them by these presents, and that no Shareholder shall be entitled to put an end to the same or to require a division of the trust estate or any part thereof until the expiration of seventy-five (75) years from the formal date hereof, or the expiration of twenty (20) years from the death of the last survivor of the following persons: [names omitted] . . . all in the Commonwealth of Massachusetts, whichever of the said periods shall first expire, and at the expiration of the time so limited the said trusts shall terminate.

138. For example, § 4(a) of the Declaration of Trust of Fidelity Daily Income Trust dated March 1, 1974, states that the trust "shall continue without limitation of time" subject to provisions which permit the trustees and shareholders to sell the trust assets and terminate the trust.

III. USE OF BUSINESS TRUSTS FOR INVESTMENT COMPANIES

A. Investment Companies Until 1940

In 1920, the first investment company, Overseas Security Corporation, was established in the United States.[139] Many of the early investment companies were organized as Massachusetts business trusts, including International Securities Trust of America (1920), Bond Investment Trust (1923), and American Founders Trust (1925).[140] The first investment company to be "open-end," which means a company whose shares are redeemable at the option of the holder, was Massachusetts Investors Trust, formed in 1924.[141] The majority of investment company assets in the 1920's were held by closed-end investment companies.[142] By 1929, out of a total of 677 investment companies, each with assets of more than $500,000, with aggregate assets of $8 billion,[143] only 19 were open-end companies aggregating $140 million in assets.[144]

After the 1929 stock market collapse, the number of investment companies decreased from 728 at the end of 1930 to 560 at the end of 1936.[145] During that period, although new investment companies were organized, approximately 700 investment companies dissolved or became bankrupt.[146] In addition, the market value of investment company assets declined from approximately $6.3 billion in 1929 to a low of $2.5 billion in 1932.[147] Open-end investment companies, however, suffered less severely during the Depression than closed-end investment companies,[148] and by 1936 total assets of open-end investment companies had increased from $75 million in 1932 to $506 million.[149]

At the same time, assets of investment companies headquartered in Boston increased from 7% of total investment company assets in 1929 to 21% of investment company assets in 1936. This growth

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139. *See* GRAYSON, *supra* note 21, at 138.
140. *Id.* at 138, 168.
141. *Wharton Report*, *supra* note 40, at 4.
142. *Id.* at 37. In contrast to open-end investment companies, closed-end investment companies do not stand ready to redeem their shares. *See supra* note 1.
143. *1939 SEC Letter*, *supra* note 40, at 29-32.
144. *Wharton Report*, *supra* note 40, at 37.
145. *1939 SEC Letter*, *supra* note 40, at 29.
146. *Id.* at 30.
147. *Id.*
148. *Wharton Report*, *supra* note 40, at 38.
149. *Id.*

was primarily due to the strength of three open-end investment companies: Massachusetts Investors Trust, Incorporated Investors, and State Street Investment Co.[150] Massachusetts Investors Trust was the largest open-end company, with assets which had increased from $14.5 million in 1929 to $130.3 million in 1936.[151] By this time, Incorporated Investors and State Street Investment Co. each had assets in excess of $25 million.[152] In 1936, Massachusetts Investors Trust held 25.7% of all open-end investment company assets and the four largest investment companies held 60.6% of all open-end investment company assets.[153]

The organizers of many of the early business trusts believed that the trust vehicle would not be subject to the federal corporate income tax.[154] This belief was confirmed in 1919 when the United States Supreme Court held, in *Crocker v. Malley*,[155] that a Massachusetts business trust was not liable for federal corporate income taxes under the Revenue Act of 1913.[156] In 1923, however, the Supreme Court held, in *Hecht v. Malley*,[157] that a Massachusetts business trust was an "association" and that the Revenue Act of 1918 defined the term "corporation" to include "association"; therefore, the Court held that Massachusetts business trusts were taxable as corporations.[158] Even after 1923, many business trusts attempted to escape federal taxation by claiming to be outside the scope of the definition of "corporation" in *Hecht*.[159] In determining that any particular business trust was taxable, the Court in *Hecht* stated that when trustees "are not merely trustees for collecting funds and paying them over, but

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150. *1939 SEC Letter*, *supra* note 40, at 61 n.44. The report stated that the "growth of these companies was due primarily to new capital raised by the continuous sale of their securities in a period when virtually no securities of closed-end management investment companies proper were sold." *Id.*

151. *Wharton Report*, *supra* note 40, at 38.

152. *Id.*

153. *Id.*

154. *See, e.g.*, S. WRIGHTINGTON, THE LAW OF UNINCORPORATED ASSOCIATIONS AND BUSINESS TRUSTS 193 (1916).

155. 249 U.S. 223 (1919).

156. *Id.* at 235.

157. 265 U.S. 144 (1923).

158. *Id.* at 156-57. In *Hecht*, the trustees of three Massachusetts trusts brought suit for refunds of excise taxes assessed against them as "associations" under the Revenue Acts of 1916 and 1918. *Id.* at 145-56.

159. *See generally* Rottschaefer, *Massachusetts Trust Under Federal Tax Law*, 25 COLUM. L. REV. 305 (1925) (discussing federal tax status of trusts under Revenue Acts of 1918, 1921, and 1924 and analysis of *Crocker* and *Hecht*).

are associated together in much the same manner as the directors in a corporation for the purpose of carrying on business enterprises, the trusts are to be deemed associations."[160] Whether business trusts were taxable generally as corporations remained unclear until 1935 when the Supreme Court decided in *Morrissey v. Commissioner of Internal Revenue*[161] that a business trust which was "created and maintained as a medium for the carrying on of a business enterprise and sharing its gains"[162] was "sufficiently analogous to corporate organization to justify the conclusion that Congress intended that the income of the enterprise should be taxed in the same manner as corporations."[163] The Revenue Act of 1935 also reduced the dividends-received deduction from 100% to 90%. This resulted in a tax on 10% of dividends received by one corporation from another corporation,[164] adding to the significance of a Massachusetts business trust's classification as a corporation for tax purposes.

The enactment of the Revenue Act of 1936 laid the basis for the modern investment company business by providing for conduit or pass-through treatment for investment companies under certain conditions.[165] The Revenue Act of 1936 provided that "mutual investment companies" could deduct the amount of dividends paid to shareholders from the company's taxable income if the company: (1) distributed at least 90% of its net income to shareholders; (2) derived at least 95% of its gross income from dividends, interest, and gains from sales or other disposition of securities; (3) derived less than 30% of gross income from the sale or other disposition of securities held for less than six months; and (4) qualified as a "mutual investment company" by: (a) holding no more than 5% of its gross assets in securities of any one corporation, government or political subdivision (except for government obligations), (b) holding no more than 10% of the outstanding securities of a corporation, and (c) having no indebtedness in excess of 10% of its gross assets.[166] The Internal Revenue Codes of 1939 and 1954 continued conduit treatment for

160. *Hecht*, 265 U.S. at 161.

161. 296 U.S. 344 (1935).

162. *Id.* at 359.

163. *Id.* at 360. In *Morrissey*, the trustees of an express trust contested income taxes levied against them for the years 1924-1926 on the grounds that the trust was not an association. *Id.* at 346.

164. Revenue Act of 1935, Pub. L. No. 407, § 102(h), 49 Stat. 1015 (1935) (amended 1954).

165. Revenue Act of 1936, Pub. L. No. 740, 49 Stat. 1648 (1936).

166. *Id.* § 48(e).

investment companies and contained provisions similar to those enacted in 1936.[167] The current version of the Internal Revenue Code (Code), as amended,[168] provides in Subchapter M that a qualifying regulated investment company (RIC), which distributes at least 90% of its taxable and tax-exempt net investment income, is not subject to federal income tax to the extent of its annual distributions under certain conditions.[169]

The other major reason for the growth of the investment company industry was the passage of the Investment Company Act of 1940.[170] Congress passed the 1940 Act as one of the series of securities acts designed to protect investors from abuses in the securities industry.[171] Earlier legislation included the Securities Act of 1933 (1933 Act),[172] the Securities Exchange Act of 1934 (1934 Act),[173] the Public Utility Holding Company Act of 1935,[174] and the Trust Indenture Act of 1939.[175] In 1940, Congress determined that:

> [the 1933 Act and the 1934 Act] have been ineffective to

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167. *See* I.R.C. § 361 (1939); I.R.C. § 52 (1954).

168. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). I.R.C. § 52 (1986).

169. Current qualification requirements for a RIC are very similar to the requirements in the Revenue Act of 1936. To qualify under Subchapter M, an investment company must do the following: (1) elect to be treated as a RIC; (2) derive 90% of its gross income from dividends, interest, securities loan payments, and gains from the sale or other disposition of securities and certain other gains from foreign currencies, options, futures or forward contracts; (3) derive less than 30% of gross income from the sale or other disposition of securities held for less than 3 months; (4) at the close of each quarter, hold at least 50% of the value of its total assets in cash and cash items, Government securities and securities of other regulated investment companies, and in other securities with respect to which the securities of any one issuer cannot exceed more than 5% of the value of the total assets of the RIC or more than 10% of the outstanding voting securities of the issuer; and (5) at the close of each quarter, invest not more than 25% of the value of its total assets in securities (other than Government securities or the securities of other RIC's) of any other issuer. I.R.C. §§ 851-852. *See also* R. HERVEY, TAXATION OF REGULATED INVESTMENT COMPANIES (TAX MANAGEMENT PORTFOLIO) (1987).

170. 15 U.S.C. § 80a-1 (1987). *See* Phillips, *Deregulation Under the Investment Company Act—A Revaluation of the Corporate Paraphernalia of Shareholder Voting and Board of Directors*, 37 BUS. LAW. 903 (1982); Motley, Jackson & Barnard, *Federal Regulation of Investment Corporations Since 1940*, 63 HARV. L. REV. 1134 (1950).

171. *See, e.g.*, President's Statement on the signing of the Investment Company and Investment Advisers Act of 1940, dated August 23, 1940, *printed in* Appendix of the Cong. Rec. (Aug. 26, 1940), *reprinted in* 4 FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY—1933-1982, at 3914-15.

172. Pub. L. No. 73-22, 48 Stat. 74 (1933).

173. Pub. L. No. 73-291, 48 Stat. 881 (1934).

174. Pub. L. No. 74-333, 49 Stat. 803 (1935).

175. Pub. L. No. 76-253, 53 Stat. 1149 (1939).

> correct abuses and deficiencies in investment companies: first, because . . . publicity alone, which in general is the remedy provided by these acts, is insufficient to eliminate the abuses and deficiencies which exist in investment companies; and, second, because a large number of such companies have never come under the purview of these acts.[176]

The abuses in the investment company industry are described in the following report of the Committee on Banking and Currency:

> Basically the problems flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile, and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements and have been employed to foster their personal interests rather than the interests of public security holders. It is obvious that in the absence of regulatory legislation, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies and that deficiencies which have occurred in the past will continue to occur in the future.[177]

The report added, however, that need for the 1940 Act did not imply that most investment companies were guilty of unfair practices or were mismanaged.[178] In fact, investment company representatives actively supported the 1940 Act and participated in its formulation.[179]

The authors believe that regulation by the Securities and Exchange Commission pursuant to the 1940 Act laid the groundwork for public confidence in the investment company industry and that

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176. Investment Company Act of 1940 and Investment Advisors Act of 1940. Report of the Committee on Banking and Currency, Cong. Record (Aug. 8, 1940), *reprinted in* 4 FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY—1933-1982, at 3907-08 (1983).

177. *Id.* at 3905.

178. *Id.* at 3907.

179. *Id. See also* Motley, Jackson & Barnard, *supra* note 170.

the 1940 Act has been one of the factors allowing the enormous growth of the industry.[180]

2. Investment Companies After 1940

The 1940 Act recognized the business trust form of organization, as well as the corporate form, for an investment company in section 2(8),[181] which defines the term "company" to mean "a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not."[182] The provisions of the 1940 Act do not generally differentiate between a trust and a corporation. For example, trustees are included in the definition of the word "director."[183] Section 16(c) of the 1940 Act, however, does "grandfather" certain pre-1940 trust practices.[184]

The first major investment company study undertaken after passage of the 1940 Act, the Wharton Report, revealed that the use of business trusts for new investment companies declined after the passage of the 1940 Act.[185] Nonetheless, existing business trusts continued to hold a significant percentage of the total assets of all investment companies.[186] In 1958, Massachusetts Investors Trust, the Eaton and Howard trusts, the Keystone trusts, and Century Shares Trust held $2.8 billion in assets, or 19.6% of all open-end investment company assets.[187] The Wharton Report also stated that only two of the 38 open-end investment companies organized between 1952 and 1958 were established as trusts,[188] and that only 39 out of 156 open-end

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180. Investment Company Institute, *1988 Mutual Fund Fact Book* 62-64 (1988).

181. 15 U.S.C. § 80a-2(8) (1987).

182. *Id.*

183. 15 U.S.C. § 80a-2(12) (1987) provides in relevant part: "Director means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated . . . including any natural person who is a member of a board of trustees of a management company created as a common law trust."

184. 15 U.S.C. § 80a-16(c) (1987) (§ 16 requirements for the election of directors "shall not apply to a common-law trust existing on the date of enactment of this title under an indenture of trust which does not provide for the election of trustees by the shareholders").

185. *Wharton Report*, *supra* note 40, at 45.

186. *Id.* In 1958, 30 investment companies in the form of trusts held a total of 20.4% of the total investment companies' assets. *Id.*

187. *Id.* at 46.

188. *Id.* at 45.

investment companies surveyed were trusts.[189] Twenty-seven of these 39, or 69%, were Massachusetts business trusts.[190]

The Wharton Report attributed the decline of the business trust form of organization to several causes. The first was the spread of investment companies outside of Massachusetts.[191] The second was that section 16 of the 1940 Act required the holding of annual shareholder meetings to elect trustees, which in turn would subject the shareholders to liability as partners for the obligations of the trust.[192] This conclusion, however, failed to give any weight to the holding in the *Springfield* case, where the Massachusetts Supreme Judicial Court had held that even though a declaration of trust granted shareholders the right to hold annual meetings, the declaration created, at least for tax purposes, a trust rather than a partnership.[193]

The Wharton Report's view of section 16 ultimately proved to be incorrect. Section 16 provides that directors and trustees of a registered investment company may not serve "unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose" and that if classes of directors and trustees exist, the term of at least one class of directors or trustees must expire every year.[194] The presence of an exception to these requirements grandfathering trusts organized prior to the date of enactment of the 1940 Act, where a declaration of trust did not provide for the election of trustees by shareholders, was interpreted by the Wharton reporters to mean that section 16 required annual election of trustees.[195] However, in 1974,

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189. *Id.* at 44. The total number of open-end investment companies as of June 30, 1961, was 330. *Id.* at 40.

190. *Id.* at 44.

191. *Id.* at 45. According to the *Wharton Report*, of the 156 companies responding to the questionnaire: 51 were chartered in Delaware; 25 in Maryland; 11 in Massachusetts; 8 in Canada; 6 in New York; and the rest were distributed among 8 other states. *Id.* at 44.

192. *Id.* at 45. *See also* Frost v. Thompson, 219 Mass. 360, 106 N.E. 1009 (1914); Williams v. Inhabitants of Milton, 215 Mass. 1, 102 N.E. 355 (1913).

193. *Wharton Report*, *supra* note 40, at 45. *See also supra* notes 111-13 and accompanying text.

194. *Wharton Report*, *supra* note 40, at 45.

195. *Id.* at 45. The *Wharton Report* stated, "All newly formed trusts must provide for annual elections of trustees." *Id.* The report goes on to point out that "[t]he Act permits staggered elections of boards of directors, provided that no class of directors is elected for a period of longer than five years, and that the term of office of at least one class expires each year." *Id.* at 46. This seems consistent with 15 U.S.C. § 16(a). The report, however, noted the rarity of staggered elections among

the registration statement of Fidelity Daily Income Trust[195] was declared effective by the staff of the SEC notwithstanding that the declaration of trust did not provide for the election of trustees at an annual meeting.[197] Subject to the requirement of section 16(c), trustees served until they resigned, died or were removed.[198] It has been the authors' experience that after 1974 investment companies in trust form commonly omit the requirement to hold an annual meeting.

Business trusts were the recipients of favorable tax treatment as a result of a 1960 amendment to the Code which provided conduit taxation for real estate investment trusts (REITs).[199] A REIT is similar to an investment company except that a REIT invests in real estate property or mortgages or both, while an investment company invests primarily in securities.[200] Congress required a REIT to be a "trust or association" rather than a corporation because the law was intended to favor "passive investments"[201] rather than "active business op-

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open-ended investment companies and stated that in most cases where elections are held annually they are held for an entire board. *Id.* The report stated that "[i]n effect, then, a trust conforming to the Investment Company Act of 1940, and organized after the date of enactment of that legislation, cannot qualify as a valid common law trust under Massachusetts Law." *Id.* at 45.

196. Fidelity Daily Income Trust Registration Statement, effective May 30, 1974, File No. 2-50318. The authors believe that John W. Belash, now practicing in New York City, was the first to suggest that § 16(a) did not require registered investment companies to provide for and hold annual meetings of shareholders.

197. Declaration of Trust of Fidelity Daily Income Trust, art. VIII, § 2 (Mar. 1, 1974).

198. *Id.* art. IV, § 3.

199. Real Estate Investment Trusts Act, 74 Stat. 998, 1003 (1960). *See also* Page, *Massachusetts Real Estate Syndication: Tax and Other Pitfalls*, 43 B.U.L. REV. 491 (1963); *Real Estate Investment Trusts*, H.R. REP. No. 2020, 86th Cong., 2d Sess. (1960); Smith, *Legal Considerations in Structuring New Real Estate Investment Trusts*, 1 REAL EST. FIN. L.J. 77, 79 (1985). A REIT which meets certain requirements and distributes to shareholders all of its income and capital gains avoids tax. Among the REIT requirements are: (1) transferable shares held by 100 or more persons; (2) 90% of gross income from passive income (dividends, interest, rent from real property, gains from the sale of stock, securities and real property, and real estate abatements and refunds); (3) at least 75% of gross income from real estate rents, mortgage interest, gains from sale on real property, or other limited sources; and (4) election to be taxed as a REIT. Page, *supra*, at 513.

200. H.R. REP. No. 2020, 86th Cong., 2d Sess. 2-3 (1960). *See generally* Goff, *REIT Revival—An Overview of Real Estate Investment Trusts as an Investment Vehicle*, 39 INST. ON FED. TAX'N 19.1 (1987) (excellent general discussion of REITs).

201. The term "passive investment income" is defined as "gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities . . . ." 26 U.S.C. § 1372(c) (1986).

erations."[202] The REIT provisions in sections 856 through 859 of the Code are similar to the investment company provisions in sections 851 through 855.[203] REITs boomed during the 1960s and early 1970s and, as a result, the trust form became familiar to investors and regulators throughout the United States. Initial public offerings by REITs increased from six REITs with a total volume of less than $50 million in 1966 to 804 REITs with a total volume of almost $900 million in 1971.[204] Although in 1976 the Code was amended to permit a REIT to be organized as a corporation,[205] the existence of the REITs contributed to the general renewed awareness of the advantages of the Massachusetts business trust. This awareness carried over to investment companies registered under the 1940 Act.

Several changes in the investment company industry in the late 1960s and early 1970s also paved the way for the increased use of business trusts for investment companies. Business trusts became popular entities for money market funds which developed after 1972.[206] A money market fund is an open-end investment company which invests in short-term debt securities and instruments.[207] Generally, a money market fund attempts to maintain a fixed net asset value of $1 per share, and is intended to fill many of the same needs as a bank savings or checking account.[208] Accordingly, money market funds attract short-term investments and generally experience sales and redemptions of large numbers of shares in short periods of time.[209] Because a corporation is usually limited to issuing the maximum number of shares authorized in the certificate of incorporation, the

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202. *Id.* Congress attempted to prefer for tax purposes REITs that were principally involved in merely owning real property interests as opposed to REITs that derived income from the management of real property or associated service functions. Parker, *REIT Trustees and the Independent Contractor*, 48 VA. L. REV. 1048, 1051-55 (1962).

203. *See supra* note 169 and accompanying text.

204. Healey, *Twenty Year History of Public Financing by Qualified REITs*, 1986 REAL EST. L. & PRAC. 233.

205. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

206. *See generally* Cook & Duffield, *Money Market Mutual Funds: A Reaction to Government Regulations or a Lasting Financial Innovation?*, 65 ECON. REV. 15 (1979); *Money Market Mutual Funds: Hearings Before the Subcommittee on Financial Institutions of the Committee on Interstate and Foreign Commerce*, 96th Cong. 2d Sess. 1 (1980).

207. Adams, *Money Market Mutual Funds: Has* Glass Steagall *Been Cracked?*, 99 BANKING L.J. 4, 54 (1982).

208. In fact, critics argued that money market funds were a harbinger of doom upon the banking and savings and loan industry. *See* House Wednesday Group, Background on Money Market Funds 7 (1982).

209. *Id.* at 6-7.

need to issue large numbers of shares typically requires a money market fund in corporate form to repeatedly increase the maximum amount of its authorized capital stock.[210] Generally, an increase in the number of authorized shares of a corporation requires the affirmative vote of its shareholders under state law.[211] Conversely, a Massachusetts business trust does not require fixed authorized capital stock.[212] Furthermore, the declaration of trust can grant trustees the power to issue an unlimited number of shares of the trust without a shareholder vote.[213] Money market fund managers preferred the business trust form because a shareholders' meeting was not required to authorize new shares, thus saving expense and eliminating potential delays in authorizing shares. On the other hand, a corporation whose certificate of incorporation authorizes a large number of shares incurs significant filing fees because most state corporation filing fees increase directly with the number of authorized shares.[214] A Massachusetts business trust conveniently avoids these fees.

Additionally, the trust form also provided a solution to another problem unique to money market funds. In order to maintain a stable net asset value of $1 per share, money market funds customarily value their portfolio assets at cost, and accrue income and declare a dividend equal to net income on a daily basis.[215] Accordingly, income is never reflected in portfolio assets, whose value remains stable at cost. This works well unless the amount of accrued expenses on a particular day, or the recognition of the diminution in the value of portfolio assets for some reason such as a default, exceeds accrued income for that day. In such a case, the net asset value per share might drop below $1, but the fixed $1 price could nevertheless be maintained by reducing the number of outstanding shares by a "reverse split." Many practitioners believe that such a reverse split can be accomplished in a business trust.[216] Declarations of trust commonly

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210. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(a)(4) (1987); N.Y. BUS. CORP. §§ 402(4), 501, 502 (McKinney 1986).

211. DEL. CODE ANN. tit. 8, § 242(b)(2) (1983).

212. MASS. GEN. LAWS ANN. ch. 182 (1987) (statute does not state any limitation on the number of authorized shares of a business trust).

213. *Id.*

214. *See, e.g.*, DEL. CODE ANN. tit. 8, § 391 (1987).

215. *See* Adams, *supra* note 207, at 6-7.

216. *See generally* FLETCHER, *supra* note 7, § 3179 (generally setting forth power of trustees in business trust).

give the trustees the power to effect a reverse split.[217] It is not clear whether the directors of a corporation could exercise the same power under state corporation laws. The use of a trust avoids confronting that issue.

After business trusts began to be used for money market funds, the investment company industry became aware of the other advantages besides unlimited authorized shares, reduced filing fees and the power to effect a reverse split.[218] Once it became accepted that section 16 of the 1940 Act does not require annual shareholder meetings, many more mutual fund sponsors turned to the trust form.

Another advantage of investment companies organized as Massachusetts business trusts is that they are not subject to Massachusetts state taxes.[219] Generally, Massachusetts business trusts are subject to state taxation. The Massachusetts corporate income tax, however, is not applicable to Massachusetts business trusts which are regulated investment companies qualified under Subchapter M of the Code.[220] Further, such entities are not required to file a tax return in Massachusetts,[221] whereas investment companies organized as corporations

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217. *Cf.* G. BOGERT, TRUSTS & TRUSTEES, § 1163, ¶ 5.4 (2d rev. 1966) (amended 1983) (a model declaration of trust provides a 2/3 vote of shareholders required to reduce number of shares of business trust).

218. However, two disadvantages of Massachusetts business trusts result from the absence of a statutory framework for business trusts. First, because mergers are statutory procedures provided in corporation statutes, *see, e.g.*, DEL. CODE ANN. tit. 8, §§ 251-262 (1987), a business trust cannot be a surviving entity in a statutory merger of consolidation. The Massachusetts corporate statute has gone part way towards curing this defect by providing that a business trust in which 90% of the outstanding shares are owned by a corporation may be merged into that corporation. However, the Massachusetts business trust statute does not have parallel provisions. As a result, Massachusetts business trusts commonly avoid the problem by combining with other entities through a sale of assets or exchange of stock.

A second potential disadvantage, perhaps more psychological than legal but nevertheless real, is that foreign jurisdictions outside of the United States may be reluctant to recognize the Massachusetts business trust form compared to the more familiar corporate form. A foreign agency or court could not refer to a familiar state statutory framework, and, although many international and global funds are organized as Massachusetts business trusts, the authors understand that some fund sponsors have employed the corporate form because they feared that a Massachusetts business trust would have difficulty defending or prosecuting an action brought in foreign courts. Furthermore, a domestic investment company seeking to sell its shares outside of the United States might encounter the same resistance from foreign regulators that the early REITs did from Blue Sky regulators.

219. MASS. GEN. LAWS ANN. ch. 62, § 8 (1987).

220. *Id.*

221. *Id. See also* Barrett & DeValpine, *Taxation of Business Trusts and Other Unincorporated Massachusetts Entities with Transferable Shares*, 40 B.U.L. REV. 329 (1960).

typically are required to file a return and pay some tax in the state of incorporation.[222]

In the last decade, the introduction and popularity of separate funds for specialty investments have led to a proliferation of products and the need for mutual fund sponsors to seek ways to reduce the expense of organizing new funds. Under the 1940 Act, there is an exception to the prohibition against issuing senior securities for open-end investment companies which issue separate series of shares, each representing an interest in a different pool of assets.[223] An additional series of an existing registered investment company is not required to register as a separate new investment company, and its shares may be registered under the 1933 Act pursuant to an amendment to the effective registration statement of the "parent" since the new series consists of shares of the registrant.[224] Such "series funds" became a popular method of establishing new mutual funds in a shorter period of time and at considerably less cost than a new investment company. This is due to an SEC rule change in 1980 which permits a post-effective amendment to an investment company's registration statement under the 1933 Act to become effective automatically 60 days after filing.[225]

The desirability of the Massachusetts business trust as a vehicle for series funds received another dramatic boost following a 1984 private letter ruling of the Internal Revenue Service which stated that each series of a business trust (but not a corporation) could be treated as a separate taxpayer in certain circumstances.[226] As a result, funds which met the Internal Revenue Service criteria were not required to net gains and losses from portfolio transactions of different series.[227] The initial and subsequent private letter rulings all specified that in order to obtain separate taxpayer treatment for each series, the investment company could not be organized as a corporation.[228]

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222. 88 A.L.R.3d 704, § 49 (1967).

223. 15 U.S.C. § 80a-18(f)(2) (1987).

224. Rule 485(a) promulgated pursuant to the Securities Exchange Act of 1933, 17 C.F.R. § 230.485, was adopted as Rule 465 in Revised Procedures for Processing Post-Effective Amendments filed by Investment Company Act Release No. 33-6229, Fed. Sec. L. Rep. (CCH) ¶ 82,638 (Oct. 1980).

225. *Id.*

226. Priv. Ltr. Ruling 84-19-017 (Feb. 2, 1984). Before 1984, series funds were considered to be a single entity under federal tax law. Rev. Rul. 56-246, 1956-2 C.B. 316; Union Trusteed Funds, Inc. v. Commissioner, 8 T.C. 1133 (1947).

227. Priv. Ltr. Ruling 84-19-017 (Feb. 2, 1984).

228. Priv. Ltr. Ruling 85-06-065 (Nov. 13, 1985).

This advantage of the business trust was short-lived because the Tax Reform Act of 1986 amended Subchapter M of the Code to provide that each series of an investment company, whether organized as a corporation or a trust, is treated as a separate taxable entity.[229]

IV. CONCLUSION

Notwithstanding that Maryland corporations now have many of the advantages of the Massachusetts business trust form,[230] the business trust continues to offer a flexibility that corporations may not enjoy. The declaration of trust may provide that (i) no share certificates will be issued; (ii) the trustees can terminate the trust or a series without shareholder approval; (iii) the trustees may effect a "reverse split" of outstanding shares; (iv) notice of shareholders' meetings need not be given to certain shareholders whose mail is habitually returned, consistent with the SEC's proxy rules; (v) the shareholder vote required to approve an action such as a consolidation, the sale of assets or an amendment to the declaration of trust can be less than required by state corporate law or can be eliminated; and (vi) the trustees may change the name of the trust or a series without shareholder approval. The Massachusetts business trust has the flexibility to adapt to future conditions in the investment company industry which now cannot be foreseen.

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229. I.R.C. § 851(a). *See* Tax Reform Act of 1986, Pub. L. No. 99-514, tit. VI, § 654, 100 Stat. 2085 (1986).

230. *See supra* note 5.