

MEMO# 11114

July 13, 1999

COURT FINDS SECTION 36(B) PREEMPTS STATE LAW CLAIMS OF BREACH OF FIDUCIARY DUTY AND DECEIT

1 Green et al. v. Fund Asset Management, L.P. et al., Civ. No. 97-3502 (DRD)(D.N.J.)(June 14, 1999). 2 Under Section 36(b), the plaintiffs' potential recovery will be limited to the improper fees generated in the one-year period preceding the complaint and the case must be tried to the court rather than a jury. In addition, Section 36(b) precludes the certification of a nationwide class. [11114] July 13, 1999 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 26-99 DIRECTOR SERVICES COMMITTEE No. 20-99 SEC RULES MEMBERS No. 46-99 RE: COURT FINDS SECTION 36(b) PREEMPTS STATE LAW CLAIMS OF BREACH OF FIDUCIARY DUTY AND DECEIT

The United States District Court for the District of New Jersey recently dismissed state law claims for breach of fiduciary duty and deceit against several funds, their adviser, certain affiliates and two executives on the grounds that the claims were preempted by Section 36(b) of the Investment Company Act of 1940.¹ Plaintiffs, two shareholders in closed-end municipal bond funds, brought a class action suit alleging violations of various sections of the Investment Company Act. In particular, they claimed that the funds' advisory agreements created a conflict of interest because the advisory fees under the agreements were based upon the funds' net assets, including assets purchased with leverage. Plaintiffs argued that this created a disincentive on the part of the adviser to reduce or eliminate leverage when market conditions might otherwise dictate a change. The Court first granted the defendants' motion to dismiss the plaintiffs' federal claims under Sections 8(e), 34(b) and 36(a) finding that, even if they were timely (which they were not), they were precluded by the express private right of action in Section 36(b) to redress breaches of fiduciary duty involving compensation or payments to an investment adviser. The Court, in the current opinion, dismissed the plaintiffs' state law claims of breach of fiduciary duty and deceit on the grounds that they were preempted by Section 36(b). The Court noted that Congress had enacted the Investment Company 1940 Act because the nationwide activities of investment companies called for federal regulation and, more specifically, had enacted Section 36(b) because the existing remedies for improper compensation arrangements had been ineffective. In addition, the fact that some of the procedural restrictions in Section 36(b)'s liability provisions would conflict with the state law claims presented led the Court to conclude that Section 36(b) was to be the exclusive remedy for excessive advisory fees. Because this is a case of first impression, and the preemption issue could affect the outcome of the case,² the Court certified the issue for interlocutory appeal to the Third Circuit. A copy of the Court's opinion is attached. Marguerite C. Bateman Associate Counsel

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