

**MEMO# 11199**

August 20, 1999

## **COURT DISMISSES COMPLAINT IN CASE CHALLENGING DIRECTOR INDEPENDENCE**

1 Krantz v. Prudential Investments Fund Management LLC , Civ. Action No. 98-3722 (S.D.N.J. July 30, 1999) (order granting motion to dismiss). 2 Krantz v. Prudential Investments Fund Management LLC , Civ. Action No. 98-3722 (S.D.N.J. June 10, 1999) (report and recommendation). [11199] August 20, 1999 TO: BOARD OF GOVERNORS No. 54-99 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 26-99 DIRECTOR SERVICES COMMITTEE No. 23-99 SEC RULES MEMBERS No. 50-99 RE: COURT DISMISSES COMPLAINT IN CASE CHALLENGING DIRECTOR INDEPENDENCE

The United States District Court for the District of New Jersey has dismissed a mutual fund shareholder's amended complaint against the fund's investment adviser and principal underwriter (the "distributor") alleging violations of Sections 10(a) and 15(c) of the Investment Company Act of 1940 (the "Act") and breach of fiduciary duty under Section 36(b) of the Act.<sup>1</sup> The court adopted and incorporated as its opinion the Report and Recommendation of the U.S. Magistrate Judge to whom it had referred the motion to dismiss.<sup>2</sup> The court did not grant the plaintiff a second leave to amend his complaint. The plaintiff claimed that none of the fund's directors were independent as required by Section 10(a) of the Act because, through the payment of substantial fees for service on multiple fund boards, they had become "interested persons" within the meaning of the Act. The plaintiff, therefore, sought to void the management and distribution agreements between the fund and its adviser and distributor, and recover all fees paid under these agreements, on the grounds that they were not approved by a majority of the independent directors in violation of Section 15(c). The plaintiff alleged that, by virtue of their receipt of fees from invalid agreements, the adviser and distributor each breached their fiduciary duty under Section 36(b) to negotiate at arm's-length with the fund. Additionally, the plaintiff alleged that because these fees were so disproportionately large, it amounted to a breach of fiduciary duty under Section 36(b). In granting the motion to dismiss, the court found that the plaintiff failed to overcome the statutory presumption that independent directors are not "controlled persons" as defined in Section 2(a)(9) of the Act. The court noted that the defendant's sole factual allegation challenging the directors' independence – service on multiple fund boards for which they receive significant compensation – was 3 Id. at 7-8 (citing for support, Verkouteren v. Blackrock Fin. Management, Inc., 1999 WL 101394 (S.D.N.Y. Feb. 4, 1999); Migdal v. Rowe Price-Fleming Int'l Inc., Civil No. AMD-98-2162, slip. op. (D. Md. Jan. 20, 1999); Strougo v. BEA Associates, No. 98 Civ. 3725 (S.D.N.Y. Mar. 11, 1999); and Olesh v. Dreyfus Corp., 1995 WL 500491 (E.D.N.Y. Aug. 8, 1995)). The court, however, declined "to hold as a matter of law that fund directors who serve on multiple boards for which they receive substantial compensation fails to state a claim under Rule

12(b)(6)." 4 Id. at 10 (citing *Green, et al v. Fund Asset Management, L.P., et al*, 19 F. Supp. 2d 277, 234-35 (D.N.J. 1999) and *Green v. Nuveen Advisory Corp.*, 1999 WL 182212, at \*3 (N.D. Ill. Mar. 30, 1999)). 5 See *Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404, 409 (2d Cir. 1989). insufficient to establish that the directors were controlled, and therefore "interested," as courts have unanimously held.<sup>3</sup> In evaluating the claims of breach of fiduciary duty, the court stated "that receipt of compensation while breaching a fiduciary duty violates Section 36(b)." <sup>4</sup> Nonetheless, because the plaintiff failed to sufficiently allege that the non-employee directors were "interested," the court found that plaintiff's conclusion that a fiduciary breach necessarily flows from the invalid agreements must fail. The court also determined that the plaintiff's allegation of excessive fees was meritless because he only addressed one of the six factors<sup>5</sup> to be considered when determining whether fees are excessive – the independence factor – which was rendered moot by the court's earlier determination that the independent directors were not "interested." A copy of the court's order and the related Report and Recommendation are attached. Doretha VanSlyke Zornada Assistant Counsel Attachments Note: Not all recipients receive the attachments. To obtain a copy of the attachments referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachments numbered 11199. ICI Members may retrieve this Memo and its attachments from ICINet (<http://members.ici.org>).

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