The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 11759

March 23, 2000

TWO COURTS DISMISS CHALLENGES TO FUND DIRECTOR INDEPENDENCE

1 Verkouteren v. Blackrock Financial Management, Inc., No. 99-9005 (2d Cir., March 21, 2000). 2 See Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923, 928 (2d Cir. 1982). [11759] March 23, 2000 TO: BOARD OF GOVERNORS No. 17-00 CLOSED-END INVESTMENT COMPANY MEMBERS No. 4-00 INVESTMENT COMPANY DIRECTORS No. 6-00 SEC RULES MEMBERS No. 20-00 SMALL FUNDS MEMBERS No. 6-00 RE: TWO COURTS DISMISS CHALLENGES TO FUND DIRECTOR INDEPENDENCE

_____ In separate decisions, the Court of Appeals for the Second Circuit and the U.S. District Court for the District of Maryland rejected claims of breach of fiduciary duty under Section 36(b) of the Investment Company Act of 1940. In both cases, mutual fund shareholder plaintiffs had challenged the independence of the funds' directors on the bases that they served on multiple fund boards and received substantial compensation. Copies of the opinions are attached and are summarized below. Second Circuit Affirms Lower Court Dismissal of Section 36(b) Claim In the first case, the Court of Appeals for the Second Circuit issued a summary order in which it affirmed the lower court's dismissal of the plaintiff's claims under Sections 10(a), 15(c) and 36(b) of the Investment Company Act.1 In its original and amended complaints, the plaintiff had alleged that the board failed to have at least 40% independent directors, as required under the Act. In support of this contention, the plaintiff asserted that the independent directors were controlled by the adviser because they served on twenty-one boards within the fund complex for which they received substantial compensation, but lacked adequate time to perform their duties. As a result, he claimed the advisory contract could not have been negotiated at arms' length. The district court granted the defendant's motion to dismiss plaintiff's first amended complaint holding that the plaintiff had failed to plead sufficient facts to rebut the statutory presumption that natural persons cannot be controlled. The second amended complaint failed to remedy the defect and was similarly dismissed. On appeal, the Second Circuit agreed that the plaintiff had failed to allege sufficient facts to show that the adviser controlled the independent directors of the fund. The court noted that the complaint did not allege that the re-election of the independent directors or their compensation was controlled by the adviser. Furthermore, the fund shareholders voted to approve the advisory fee. The court also found that the plaintiff failed to allege sufficient facts to show that the amount of the advisory fee was "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."2 In doing so, the court reaffirmed the district court's decision to treat the complaint as based on an explicit right of action under Section 36(b) 3 Midgal v. Rowe Price-Fleming International, Inc., Civil No. AMD 98-2162 (D.Md., March 20, 2000). 4 See Gartenberg, supra n. 2. instead

of an implied right of action under Section 36(a), which would have allowed the plaintiff to avoid the Gartenberg requirements. District Court Grants Motion to Dismiss Second Amended Complaint In the second case, the U.S. District Court for the District of Maryland granted defendants' motion to dismiss the plaintiffs' second amended complaint under Section 36(b).3 In doing so, the court noted that, in order to state a cognizable claim, the plaintiffs would need to allege sufficient facts to show that the advisory fee was "so disproportionately large that it bears no reasonable relationship to the services rendered."4 In the court's view, the plaintiffs had attempted to state a claim of excessiveness/disproportionality by purporting to allege both "direct" and "indirect" violations of Section 36(b) through generalities. The court observed that, if accepted, such generalities would make it possible to state a claim in virtually any case under Section 36(b). The court rejected the allegations of a "direct" violation finding that, although the plaintiffs alleged "circumstantial" indicia of excessive fees, such allegations were legally insufficient because they were too general and "[did] not remotely touch on the issue of what, if any, relation exists between the disputed fees on the one hand, and services provided in consideration for their payment, on the other hand." The court similarly dismissed the allegations of an "indirect" violation, reaffirming the position it took when dismissing the first amended complaint in this action that "a non-employee, non-affiliate director, who is statutorily presumed to be disinterested, is not rendered interested or non-independent by virtue of the number of interlocking boards on which she or he serves within a family of funds." The court stated that this is true despite the level of aggregate income, "at least so long as the aggregate payment is not so large as to shock the conscience of a reasonable person." The court declined to accept plaintiffs' contention that the human capacity for useful work and independent judgment is exceeded by service on more than thirty fund boards. The court concluded that proof that the disinterested directors had even a significant financial incentive to curry favor with the funds and their investment advisers would not sustain a claim under Section 36(b). The complaint was dismissed with prejudice. Marguerite C. Bateman Associate Counsel Attachments

---