

MEMO# 14917

July 12, 2002

APPEALS COURT AFFIRMS SUMMARY JUDGMENT RULING IN SECTION 36(B) CASE

[14917] July 12, 2002 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 25-02 DIRECTOR SERVICES COMMITTEE No. 6-02 SEC RULES MEMBERS No. 50-02 RE: APPEALS COURT AFFIRMS SUMMARY JUDGMENT RULING IN SECTION 36(b) CASE The Seventh Circuit Court of Appeals recently affirmed a grant of summary judgment in a case alleging breach of fiduciary duty under Section 36(b) of the Investment Company Act of 1940.* The case was brought by common shareholders of six closed-end, tax-exempt municipal bond funds. The funds in this case were leveraged to increase the amount of income generated. The plaintiffs argued that the advisory fee, which was based on a percentage of the daily net assets of the funds, created an incentive on the part of the adviser to excessively leverage the funds. They further argued that this fee arrangement, in turn, created a conflict of interest for the adviser and amounted to a per se breach of fiduciary duty. The district court had found that the plaintiffs failed to meet their burden of establishing a breach of fiduciary duty under Section 36(b). The Seventh Circuit agreed and said that, while an abuse of an inherent conflict may violate Section 36(b), the mere existence of the conflict does not. The court noted as significant the fact that the adviser in this case did not have the authority to make final leveraging decisions for the fund; the directors maintained ultimate control over the extent of the funds' leverage and the decision whether or not to deleverage at any given time. The appeals court also noted that investment company adviser compensation schemes are commonly based on a percentage of assets. The mere fact that this scheme could create an incentive for advisers to keep an investment fund leveraged to an extent that may not be best for a fund's common shareholders does not, by itself, create a breach of fiduciary duty under Section 36(b). Moreover, the court observed, such arrangements are expressly approved of by the Investment Advisers Act. * Green v. Nuveen Advisory Corp., Case No. 01-3671 (7th Cir., July 8, 2002). 2 The court affirmed the lower court's ruling, finding that the plaintiffs had failed to produce any evidence showing that the adviser actually abused its position. The court determined that the existence of an independent board that ultimately controlled the extent of the funds' leverage and annually approved the advisory compensation agreements, supports summary judgment in this case. Marguerite C. Bateman Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 14917, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14917. Attachment (in .pdf format)

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.