

MEMO# 14531

March 13, 2002

SECOND CIRCUIT COURT OF APPEALS VACATES AND REMANDS DISTRICT COURT DISMISSAL OF CLASS ACTION CLAIMS

[14531] March 13, 2002 TO: BOARD OF GOVERNORS No. 9-02 CLOSED-END INVESTMENT COMPANY MEMBERS No. 10-02 DIRECTOR SERVICES COMMITTEE No. 3-02 SEC RULES MEMBERS No. 18-02 RE: SECOND CIRCUIT COURT OF APPEALS VACATES AND REMANDS DISTRICT COURT DISMISSAL OF CLASS ACTION CLAIMS The United States Court of Appeals for the Second Circuit vacated and remanded a District Court dismissal of a plaintiff shareholder's class action claims.¹ Those claims alleged that the defendant directors, officers, and investment adviser of a closed-end investment fund breached their fiduciary duties at common law and under the Investment Company Act of 1940 (the "Act") in connection with the fund's use of a non-transferable rights offering. The complaint included three direct class action claims on behalf of all shareholders, alleging specifically that: 1) the defendants, by approving the rights offering, breached their duties of loyalty and care at common law and in violation of Sections 36(a) and (b) of the Act; 2) certain defendants violated Section 48 of the Act because of their positions of authority and control at the fund; and 3) these breaches of duty resulted in four kinds of injury to shareholders – loss of share value because of the various costs associated with the rights offering, downward pressure on prices because of the supply of new shares, downward pressure on the share prices resulting from the offering of shares at a discount, and injury resulting from coercion (because, the plaintiff alleged, shareholders were either forced to participate or suffer a substantial dilution.) The District Court dismissed the claims on the grounds that the injuries alleged "applied to the shareholders as a whole" and redress for the injuries could only be sought through derivative, not direct, claims.² The Second Circuit rejected the "undifferentiated effect on shareholders" standard relied upon by the District Court and instead looked to Maryland law to determine whether a shareholder may bring a direct suit. It determined that the proper inquiry under Maryland law is not whether the shareholders suffered a loss, but whether the shareholders' loss is "distinct" from that suffered by the corporation. If not, the corporation alone has a cause of action to 1 *Strougo v. Bassini, et al.*, Case No. 00-9303 (2nd Cir., February 28, 2002). 2 *Strougo v. Bassini, et al.*, 1 F. Supp.2d 268 (S.D.N.Y. 1998). 2 recover and shareholders may, at most, sue derivatively. If the shareholders' injury is distinct from that of the corporation, the shareholders have standing and may bring a direct suit, even though the harm was suffered by all shareholders equally. The Second Circuit also found that there was no basis in Maryland law for the defendants' claim that directors and officers cannot be sued directly by shareholders for alleged breaches of fiduciary duty. Instead, the court determined that,

although Maryland case law is silent on the narrow issue of direct claims, Maryland courts have clearly established that directors and officers owe fiduciary duties to both the corporation and the shareholders. To disallow direct claims by shareholders would be to say that such duties do not give rise to enforceable rights. The Second Circuit found that the plaintiff's claim relating to a loss in share value resulting from the "substantial underwriting and other transactional costs associated with the rights offering" could not support direct claims under Maryland law. The remaining alleged injuries described a set of harms resulting from the coercive nature of the rights offering. The court found that these injuries did not derive from a reduction in the value of the fund's assets or any other injury to the fund's business. Accordingly, the injuries were to the shareholders alone and not to the fund so they constitute "distinct "injuries supporting direct shareholder claims under Maryland law. Having decided the nature of the claims, the court next addressed the choice of law issue. It found nothing in the Maryland law relating to shareholder standing -- whether the plaintiff may bring direct claims against the defendant -- that would frustrate the policy objectives underlying the Investment Company Act. Accordingly, it determined that Maryland law should decide the shareholder standing issue raised by the plaintiff's claims under the Investment Company Act. The Second Circuit remanded the case to the District Court for a decision on the merits of the direct claims. A copy of the order is attached. 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 14531, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14531.

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