The Asset Management Industry
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COURT DISMISSES DERIVATIVE ACTION AGAINST FUND, ADVISER AND INDEPENDENT DIRECTORS

1 Strougo v. Padegs, et al., 96 Civ. 2136 (S.D.N.Y. 1998). [10542] December 8, 1998 TO: BOARD OF GOVERNORS No. 81-98 CLOSED-END INVESTMENT COMPANY MEMBERS No. 44-98 DIRECTOR SERVICES COMMITTEE No. 10-98 SEC RULES MEMBERS No. 106-98 RE: COURT DISMISSES DERIVATIVE ACTION AGAINST FUND, ADVISER AND INDEPENDENT DIRECTORS ____ The United States District Court for the Southern District of New York has dismissed the shareholder derivative complaint against a closed-end fund (the "Fund"), its adviser (the "Adviser"), and directors.1 The derivative complaint, which consisted of claims of breach of fiduciary duty under Maryland law and Section 36(a) of the Investment Company Act of 1940 and control person liability under Section 48(a), alleged improprieties arising out of a rights offering in 1995. According to the plaintiff, the rights offering by the Fund was designed to increase payments to the Adviser. The plaintiff alleged that the result of the rights offering was a dilution of the value of holdings by existing shareholders and a decrease in the market value of the shares. The court dismissed the claims after reviewing a report of the special litigation committee (the "SLC") of the Fund's board of directors, in which the SLC determined that the derivative action would not be in the best interest of the Fund and its shareholders. In evaluating the claims of breach of fiduciary duty and control person liability, the court inquired into the independence and good faith of the SLC and the bases supporting its conclusions. The court found that the record showed that the SLC operated and deliberated independently of the Adviser, the Adviser's directors, and the independent directors. Addressing the plaintiff's specific allegations, the court found that the structural bias of the SLC (i.e., bias that may exist because the SLC members are appointed by the defendant directors and share a common experience with these directors) did not compromise its independence; a member of the SLC that originally approved the rights offering and that voted to dismiss the complaint as a member of the Fund's board was not necessarily prejudiced in his review of the evidence; and a challenge to another SLC member's independence was insufficient to show that the SLC member did not act in the best interest of Fund shareholders. The court also found the fact that an SLC member has been recommended by Fund counsel insufficient to compromise his independence. Important to the court in its determination of the SLC's independence was the appointment of independent counsel to the SLC. The court also found that the SLC demonstrated good faith in preparing its report. The court noted that the SLC conducted a thorough and diligent investigation, after which it reached the following conclusions. First, there was no basis in fact for the plaintiff's allegations. The SLC's report concluded 2 The Fund invests almost exclusively in securities of Brazilian companies. that the rights offering was motivated by

the desire to take advantage of investment opportunities in Brazil2 and that the Adviser and the directors of the Fund believed that the decline in the Fund's stock price was attributable primarily to the devaluation of Mexico's currency and not any underlying economic problems in Brazil. The report found that the directors considered the impact of the rights offering on existing shareholders and on the market price of shares, various issues with regard to the setting of the subscription price, and the anticipated expenses of the rights offering. Second, the SLC concluded that the continuation of the lawsuit was not justified on the basis of any potential recovery from defendants for harm to the Fund because the offering was oversubscribed and, although there was a near-term drop in the price of the Fund's stock due to the offering, the price rebounded in six weeks. Further, the rights offering benefited shareholders because the Fund was able to take advantage of investment opportunities in Brazil without selling existing assets, which would have triggered taxes for shareholders. Third, the suit would be costly, distracting and result in negative unjustified publicity for the Fund. As a result of these findings, the court determined that the SLC reached a reasonable conclusion -- that the Adviser and the directors did not breach their respective fiduciary duties of loyalty and care by the development and implementation of the rights offering. As the final stage of its analysis, the court applied its business judgment to the facts of the case and found that there was no basis to permit the action to go forward. The plaintiff's core liability theory, breach of fiduciary duty under Section 36(a), would not likely prevail or benefit the Fund, on whose behalf the derivative claim was presented. Once this count was dismissed, the Section 48(a) claim also failed for want of a predicate violation. A copy of the court's opinion is attached. Marguerite C. Bateman Associate Counsel Attachment