INVESTMENT COMPANY INSTITUTE

MEMO# 12785

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COURT GRANTS MOTION TO TERMINATE DERIVATIVE ACTION AGAINST FUND, ADVISER AND DIRECTORS

[12785] October 25, 2000 TO: BOARD OF GOVERNORS No. 63-00 CLOSED-END INVESTMENT COMPANY MEMBERS No. 24-00 DIRECTOR SERVICES COMMITTEE No. 16-00 SEC RULES MEMBERS No. 73-00 RE: COURT GRANTS MOTION TO TERMINATE DERIVATIVE ACTION AGAINST FUND, ADVISER AND DIRECTORS The United States District Court for the Southern District of New York has granted a motion to terminate a shareholder derivative action against a closed-end fund and the fund's investment adviser and directors.1 The derivative claims, consisting of breach of fiduciary duty under Section 36(a) of the Investment Company Act of 1940 and Maryland common law and control person liability under Section 48(a) of the Act, were based on alleged improprieties in connection with a 1996 rights offering conducted by the fund. The plaintiff alleged that the offering diluted fund shareholders' investments, imposed transaction costs on the fund, and was motivated by a desire to increase the fund's advisory fee rather than to benefit shareholders. The court granted the defendants' motion to terminate the derivative action after reviewing a report of a special litigation committee ("SLC") of the fund's board of directors, which concluded that the continued prosecution of the action was not in the best interests of the fund or its shareholders. The court applied a two-step standard of review, which involved first evaluating the independence and good faith of the SLC and the bases supporting its conclusions, and then applying its own business judgment to determine whether the motion should be granted. The court found that the SLC acted independently, specifically rejecting the plaintiff's contentions that such independence was compromised by structural bias (i.e., because the SLC was appointed by the interested directors). The court further found that certain other factors and circumstances cited by the plaintiff regarding the two members of the SLC did not demonstrate a relationship of the SLC members with, or influence by, interested directors. The lack of any such relationship or influence, along with the timing of appointment of the SLC members (both of whom were appointed to the fund's board more than one year after the complaint was filed 1 Strougo v. Bassini, et al., Case No. 99 Civ. 3579 (S.D.N.Y. September 8, 2000). The facts of this case and the court's decision are very similar to those in an earlier, related action, Strougo v. Padegs. See Memorandum to Board of Governors No. 81-98, Closed-End Fund Investment Company Members No. 44-98, Director Services Committee No. 10-98 and SEC Rules Members No. 106-98, dated December 8, 1998. 2and almost two years after the rights offering was completed) persuaded the court that the SLC members acted independently. The court also found that the SLC acted in good faith, conducting its investigation in a thorough and diligent manner. The court noted that the SLC interviewed 11 witnesses, conducted a comprehensive review of approximately 36,000 pages of documents, requested documents from defendants

throughout the course of its investigation and prepared memoranda of its interviews and meetings. In the court's view, the SLC's report and the five volumes of exhibits outlining the SLC's reconstruction of the history of the events surrounding the plaintiff's allegations and the SLC's findings and conclusions constituted a reasonable investigation, demonstrating the SLC's good faith. In addition, the court found that the SLC had reasonable bases for its conclusions that (1) there was no basis in fact for the allegations set forth in the complaint, (2) the board reasonably concluded in mid-1996 that a rights offering was the best way for shareholders to take advantage of what were reasonably seen to be significant investment opportunities in Brazil, and (3) continuation of the lawsuit was not in the best interests of the fund and its shareholders. The court indicated that the SLC's final report contained ample support for the SLC's findings that the fund's investment adviser and directors did not breach their respective fiduciary duties of loyalty and care by the development and implementation of the rights offering. In the second step of its analysis, the court found that the SLC's determination reflected sound business judgment. The court expressed its view that the plaintiff's core liability theory – breach of fiduciary duty by the development and implementation of the rights offering – was unlikely to prevail. In finding that there was no basis on the grounds of business judgment to permit the action to go forward, the court also considered and rejected the plaintiff's theory of damages that could be recouped by continued litigation. Having found that the findings of the SLC were made independently, reasonably and in good faith, and that the "stockholder grievance [did] not merit further consideration in the corporation's interest," the court granted the defendants' motion to terminate the action. A copy of the court's order is attached. Frances M. Stadler Deputy Senior Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 12785. ICI Members may retrieve this memo and its attachment from ICINet (http://members.ici.org). Attachment (in .pdf format)