

Closed-End Fund Litigation Overview and Update

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Agenda

1. Control Share Provisions
2. Breach of Fiduciary Duty Claims
3. Director Elections

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1. **Control Share Provisions**
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Control Share Provisions – Relevant Laws

- Some states' laws allow funds to restrict a shareholder from voting shares held above a certain threshold.
 - Delaware statutory trusts: 10% threshold, automatic.
 - Maryland statutory trusts: 10% threshold, automatic for new funds formed on or after October 1, 2023, with a grandfather provision for existing funds that opted-in to the Maryland Control Share Acquisition Act.
 - Maryland corporations: 10% threshold, opt-in.
 - Other shareholders can vote to allow control shares to be voted.
- Some other states' laws are silent on control shares.
 - Massachusetts business trusts.
- The Investment Company Act – Section 18(i)
 - “Except ... as otherwise required by law, every share of stock ... issued by a registered management company ... shall be a voting stock and have equal voting rights with every other outstanding voting stock ...”

Control Share Provisions – SEC Position

- 2010 “Boulder” SEC Staff Interpretive Letter:
 - “...we believe that the use of the MCSAA [Maryland Control Share Acquisition Act] by the Fund to restrict the ability of certain shareholders to vote ‘control shares’...would be inconsistent with the fundamental requirements of Section 18(i) of [the 1940 Act] that every share of stock issued by the Fund be voting stock and have equal voting rights with every other outstanding voting stock.”
 - “A general discussion of the extent of the ‘otherwise required by law’ qualification in Section 18(i) is beyond the scope of this letter.”
- 2020 SEC Staff Statement:
 - “...the staff has reviewed the Boulder Letter, market developments since its issuance, and recent feedback from affected market participants. As a result, the staff has determined to withdraw the Boulder Letter....”
 - “The staff would not recommend enforcement action to the Commission against a closed-end fund under section 18(i) for opting in to and triggering a control share statute if the decision to do so...was taken with reasonable care on a basis consistent with other applicable duties and laws and the duty to the fund and its shareholders generally.”

Control Share Provisions – Recent Cases

Saba Capital v. Nuveen (S.D.N.Y. 2022)

- Nuveen-advised closed-end funds, organized as Massachusetts business trusts, each adopted a control share bylaw.
- Saba was restricted from voting stock exceeding the 10% threshold in the bylaw.
- Saba argued that the control share bylaw violated Section 18(i) of the 1940 Act.
- Nuveen argued that “the control share [bylaw] is consistent with Section 18(i) because it strips voting rights from shareholders but not from shares.”
- District Court’s holdings:
 - A stock is “voting” where the holder can “presently vote the stock.” Where a control share bylaw disallows voting, even temporarily, the stock is no longer a “voting security.”
 - Distinction between rights of shareholders and shares is “meaningless.”
 - The bylaw therefore violated the 1940 Act.
 - SEC’s withdrawal of Boulder Letter is “not...persuasive authority.”
 - Granting summary judgment to Saba, rescinding the control share bylaw.

Control Share Provisions – Recent Cases

Eaton Vance v. Saba (Mass. Superior Ct. 2023)

- Various Eaton Vance closed-end funds organized as Massachusetts business trusts adopted control share bylaws, with a 10% threshold.
- As in *Nuveen*, one question for the Court was whether the bylaw violated Section 18(i) of the 1940 Act.
- A second question for the Court was whether the Board violated its fiduciary duties in adopting the bylaw.
- Superior Court’s holdings:
 - The bylaw violated the 1940 Act’s “unambiguous requirement” that “every share of common stock must have the right to vote and must have voting power that is equivalent to that of all other stock” because it “imposes conditions on voting rights on some shares that do not exist for others” and “as a result, different shares are subject to different voting rights, which the statute does not permit.”
 - Granting summary judgment to Saba, rescinding the control share bylaw.
 - Granting summary judgment to the Board, holding that it had not violated its fiduciary duties, even though the bylaw itself violated the 1940 Act.

Control Share Provisions – Issues to Watch

- Will the *Nuveen* ruling hold up on appeal? The Second Circuit Court of Appeals held oral argument in May 2023.
- Will the *Eaton Vance* ruling be successfully appealed?
- Will courts apply the *Nuveen* and *Eaton Vance* rulings to closed-end funds organized in states whose laws contain control share statutes?
 - Both cases involved bylaws rather than state statutes.
 - Under the statutory trust statutes in Delaware and Maryland, control share provisions automatically apply.¹
 - The Maryland corporation statute allows funds to “opt in.”
 - Section 18(i) of the 1940 Act includes an exception to the “one share, one vote” rule: where a different rule is “otherwise required by law.”
 - It is possible a court may hold that control share provisions in Delaware and Maryland are “otherwise required by law,” so compatible with the Act.
 - A prior Maryland decision, *Neuberger Berman v. Lola Brown Tr.* (D. Md. 2007), upheld the application of the Maryland Control Share Acquisition Act to a fund that opted in to that statute, implicitly rejecting an argument that it was incompatible with Section 18(i) of the 1940 Act.

¹ Funds organized as statutory trusts in Maryland prior to October 1, 2023 (i.e., existing funds) must “opt in” for the control share statute to apply.

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Fiduciary Duties – Background

- Directors/trustees of closed-end funds owe the foundational duties of care and loyalty
- In general, a director/trustee must:
 - Act in good faith;
 - Act in what she reasonably believes to be the corporation's best interests; and,
 - With the care that “an ordinarily prudent person in a like position would use under similar circumstances.” *See, e.g.*, MD Corporations and Associations Code Ann. §2-405.1(c) (2021).

Fiduciary Duties – Recent Cases

- In *Eaton Vance*, Saba sued the funds' trustees, alleging they breached their fiduciary duties by adopting the control share bylaw.
- Relying on the business judgment rule, the Court found that Saba had not put forward sufficient evidence that the trustees were not independent or disinterested, or that they acted in bad faith or in self-interest to entrench their control of the funds.
- The Court found:

“...the record reflects that the Trustees had a legitimate business reason for their action...to protect the Funds’ retail shareholders from the harm they perceived that activist hedge funds like Saba could cause if they...forced short-term liquidity events, and thereby threatened retail investors’ interest in the Funds and the Funds’ viability. ...The Trustees’ interest in ensuring that any potential changes to the Funds the activists sought had the support of a majority of shareholders was a legitimate interest.”
- Under this theory, directors/trustees can vote to adopt a control share provision *without* necessarily violating their fiduciary duties, even if the control share provision is ultimately held to violate Section 18(i).
 - But it will depend on facts/circumstances of each case.

Fiduciary Duties – Recent Cases

- In its finding that the Board did not violate its fiduciary duty by adopting the control share bylaw or a majority of votes eligible to be cast threshold for director elections, the *Eaton Vance* court was complementary of the level of consideration and diligence involved in the Board's process.
- The *Eaton Vance* court noted that the Board considered the following items, among others, over the course of multiple meetings:
 - Actions by closed-end fund activists;
 - The negative effects experienced by closed-end funds subject to the liquidity events (e.g., tender offers, fund liquidations, open-ending) pursued by Saba and other activists;
 - The shareholder makeup of the funds and voter participation rates among different fund constituents;
 - The funds' limited ability to defend against activists' actions; and
 - Multiple reports from the adviser, a proxy solicitation firm and a market consultant regarding activist actions and potential actions to seek to address the funds' discounts.

Fiduciary Duties – Recent Cases

Nathanson v. Tortoise Cap. Advisors (D. Kansas) (2023)

- Plaintiff shareholders brought derivative claims on behalf of funds managed by Tortoise, against the fund advisor and the Board of Directors, alleging:
 - The funds' increased use of leverage exposed them to heightened risk of a liquidity crisis;
 - The increased use of leverage was in part driven by the fund advisor's desire to collect more fees;
 - The increased leverage in fact led to substantial losses;
 - Defendants took inadequate action to mitigate those losses; and
 - Defendants also improperly adopted defensive bylaws to limit ability of investors to elect new directors.
- Court's holding:
 - Upheld the fund's exclusive Maryland forum selection bylaw.
 - Dismissed case without prejudice on *forum non conveniens* grounds.
- Plaintiffs recently refiled the case in Maryland state court.

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Director Elections – Overview

- Director elections continue to be a focal point for activist investors.
- Activists attempt to nominate and elect their own directors to effect a liquidity event such as a tender offer, liquidation or converting to an open-end registered fund.
- May be conducted as part of a broader proxy contest, e.g., including termination of fund advisor.
- Recent cases and potential future challenges to:
 - Rejection of activist investors' nominees.
 - Refusal to count “control share” votes.
 - Stratification of Board members into classes.
 - Requirement that directors be elected by a majority of all outstanding shares entitled to vote (rather than a plurality of those that vote).
 - Other “holdover” director provisions.

Director Elections – Recent Cases

Bulldog v. First Trust (D. Mass. 2023)

- Complaint filed May 10, 2023 against Board trustees and fund advisor to a First Trust closed-end fund organized as a Massachusetts business trust.
- Allegations:
 - Poor fund performance since inception in 2015;
 - Defendants rejected two Bulldog nominees for trustee “for unspecified reasons purportedly based on the Fund’s labyrinthine Bylaws”;
 - Bulldog’s nominees would have won election, but it boycotted the annual meeting because Defendants refused to count those votes, resulting in failure to obtain a quorum, and adjournment of meeting; and
 - Board also sought to enforce a control share bylaw.
- Relief sought:
 - Declarations that (i) Bulldog’s nominees were improperly rejected, and (ii) control share bylaw unenforceable under the Act.
 - Rescission of the control share bylaw.
 - Damages for breach of fiduciary duty by the trustee Defendants.

Director Elections – Recent Cases

Templeton Global Income Fund v. Saba (S.D.N.Y. 2023)

- Background:
 - Proxy contest in which Saba proposed a competing slate of nominees and termination of the Fund’s investment adviser.
 - Saba entered into agreements with two other institutional investors to secure their votes for Saba’s nominees while purchasing their shares at a significant premium to market value without offering to all shareholders.
 - With these votes, Saba’s nominees narrowly received a majority of votes cast.
- Preliminary injunction lawsuit by the Fund:
 - Contended that Saba had filed a false and misleading proxy statement that did not disclose its voting agreements.
 - Asked Court to enjoin the seating of Saba’s nominees as trustees, require corrective disclosures, and a new meeting.
- Court denied preliminary injunction. Held that Fund had not shown it would suffer irreparable harm; Saba’s failure to identify a replacement fund manager, and a potential merger, were not sufficiently “concrete” or “irreversible” harms.
- The Fund appealed the ruling; was granted a stay; and later withdrew its lawsuit.

Thank you.