

Opinion

Opinion: Fund Boards Are Not Immune to Activists

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Activist investors frequently attack directors' board seats as a way to seek change at public companies. While closed-end fund boards are not targeted as often, they are not immune to these campaigns. Here's what they can do when they encounter one.



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Traditional Shareholder Activism

Investors can show their dissatisfaction with a board or its corporate governance practices at the ballot box in several ways.

In some cases, investors propose replacing just a few directors. Other times, investors may try to gain control of the company by pushing to replace the majority of the board. Repeat players in the closed-end fund space include Bulldog Investors, Karpus Investment Management, Western Investment and Saba Capital.

Bulldog, for example, has launched at least 42 campaigns in the past 20 years primarily seeking board representation at various funds. In these cases, activists are expressing dissatisfaction over the fund's performance and/or pushing certain agendas.

For example, they could want the fund board to take further action to close the discount between the net asset value and the fund's trading price, convert to an open-end fund, adopt a liquidation plan or change the investment adviser.

Zombie Directors

In recent years, shareholders have increasingly withheld their votes from board nominees altogether, without proposing replacement nominees. These so-called “withhold campaigns” are generally less expensive to run than traditional proxy campaigns and can end-run advance notice deadlines for director nominations.

Withhold campaigns are most effective against companies or funds that require uncontested directors to receive more votes in favor than against and which have post-election director resignation policies.

Typically in these cases, incumbent directors tender irrevocable conditional letters of resignation, and, if they’re not elected by a majority of the votes cast, a company’s corporate governance and nominating committee makes a recommendation. The board then decides whether to accept the director’s resignation.

Withhold campaigns can also be effective against companies or funds with plurality vote standards. A high percentage of withhold votes can increase the pressure on a board to change. Directors who remain on boards after failing to obtain a majority of the votes cast are often referred to as “zombie directors.”

Some funds require directors to receive the vote of a majority of the shares outstanding, not just of the votes cast. This approach can also create zombie directors. Under the laws of most states, including Delaware and Maryland where many funds are incorporated, directors hold their positions until their successors are duly elected. That means at funds that require directors to receive supporting votes from the majority of outstanding shares, incumbents will stay on the board as long as the dissident candidate does not obtain an absolute majority – even when the other candidate obtains more votes than an incumbent director.

That happened in 2016 when two Deutsche Bank closed-end funds, Deutsche Multi-Market Income Trust and Deutsche Strategic Income Trust, refused to unseat their current board members after insurgent directors that Western Investment proposed received more votes. Similar situations played out in 2010 at Deutsche’s High Income Opportunities Fund and in 2008 at its Global Commodities Stock Fund. The funds said they kept their chosen directors because none of the nominees received enough votes to be elected.

When to Remove Directors

When determining whether to unseat an incumbent director who does not receive a majority of the votes, boards should be sensitive to the views of shareholders, influential proxy advisers such as ISS, and third-party organizations, including the Council of Institutional Investors, which has been vocal against zombie directors. They should also think about how their decision will affect the elections for the following year.

However, the board remains responsible for determining whether to accept a director's resignation. As is the case with other companies, fund boards can decide to reject a director's resignation, and their decisions are protected by the business judgment rule.

Of course, fund directors should become fully informed and act deliberately and carefully when making these decisions. In doing so, they should take into consideration a number of factors, including:

- Shareholders' stated reasons for casting votes against the director and whether the board may be able to take actions to address those concerns
- The director's qualifications, including experience, expertise and perspective he or she can bring to the board
- The director's past contributions to the company
- The director's position on the board, including whether he or she serves on any committees or in leadership roles
- The overall composition of the board, including diversity of backgrounds, experience and gender.

Given the increasing prominence of withhold campaigns, fund boards would be wise to ensure they have in place a robust and proactive shareholder monitoring and engagement policy to help identify and address potential shareholder concerns.

This should include maintaining a stock watch program to help detect activist investors' accumulations as early as possible. Boards also should make sure that internal and outside counsel, public relations advisers and financial advisers have created an activism preparedness plan. Funds, like other companies, should aim to be their own activist and proactively evaluate potential vulnerabilities.