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Protecting Closed-End Investment Companies under Maryland Law

INTRODUCTION

Closed-end investment companies registered under the Investment Company Act of 1940, as amended (the "1940 Act"), have proven to be a product sought by many investors, especially individuals. Despite their appeal to long-term investors, closed-end funds have been subjected to persistent attack over many years by arbitrageurs and some stockholder activists with very different objectives from other investors. Many closed-end investment companies are formed as Maryland corporations and we have advised numerous closed-end funds on matters of Maryland law in responding to stockholder activism. We have observed, as have others, that the motivations of these activist stockholders vary. Some activists are arbitrageurs attempting to make a short-term profit in funds trading at a discount to net asset value by purchasing shares at the discount and then exerting pressure on the fund to open-end, liquidate or take other actions to eliminate the discount. Other activists apparently have different motives, such as obtaining control of a fund in order to replace the existing advisor with a new advisor, perhaps one affiliated with the activist stockholder.

In light of these developments, and giving due consideration to their legal duties, to the current corporate environment and to related reform initiatives, the boards of closed-end funds formed as Maryland corporations may wish to periodically evaluate various options available under Maryland law with a view to positioning each fund to defend its corporate existence against arbitrageurs and other stockholder activists seeking to destroy it.[1] In addition, advisers forming new closed-end funds should consider adopting each of the following provisions at the inception of the fund. Given the continuing interest in closed-end fund governance, we are updating our earlier memoranda on protecting closed-end funds.

DEFENSES AVAILABLE TO CLOSED-END FUNDS UNDER MARYLAND LAW

Any action taken by the board of directors of a Maryland corporation related to stockholder activism will be subject to the standards of conduct for directors under Maryland law. Unlike Delaware, the Maryland General Corporation Law (the "MGCL") includes a three-part standard of conduct for directors of Maryland corporations. This standard, set forth in Section 2-405.1(a) of the MGCL, requires each director to act (a) in good faith, (b) with a reasonable belief that his or her action is in the best interests of the corporation and (c) with the

[1] Most of the provisions discussed in this memorandum operate in the same manner for Maryland corporations that are closed-end investment companies that have elected to be treated as business development companies under the 1940 Act.

care of an ordinarily prudent person in a like position under similar circumstances. It is important to note that this standard applies individually, director by director, and not collectively to the board.

This standard of conduct should be carefully considered in connection with each of the possible actions described below. In this period of increased activism by some stockholders with goals not shared by other stockholders, we believe it is important to emphasize to directors of closed-end funds their statutory obligation to act with a reasonable belief that their actions are in "the best interests of the corporation" as a continuing entity rather than in the interest of any particular stockholder or group of stockholders. Insurgent stockholders, in particular, often have a specific agenda that may not be shared by other stockholders and that may not be consistent with the long-term interests of the fund.

1. Classified Board of Directors; Subtitle 8 Opt-In. Classified boards have existed for generations as a means of enhancing continuity and stability in the development and execution of corporate strategies. Classified boards also contribute to board effectiveness by helping to attract and retain individuals willing to commit the time necessary to understand the company, especially prospective independent directors who may be asked to serve on the audit, compensation or corporate governance committees. In addition, a classified board will slow down an unfriendly attempt to take control of the board of a fund, as the insurgents must generally win two annual elections to take control. Moreover, under the MGCL, unless the charter provides otherwise, a director on a classified board may be removed only for cause. The MGCL provides different mechanisms by which a board may be classified, including amendment of the bylaws and election by the board, on behalf of the fund, to classify the board under Title 3, Subtitle 8 of the MGCL ("Subtitle 8"), notwithstanding any contrary provision in the charter or bylaws. While an election under Subtitle 8 is subject to certain statutory requirements, it provides distinct advantages which we would be happy to discuss further.

2. Additional Subtitle 8 Provisions Relating to Directors. Under Subtitle 8, subject to applicable requirements, a board may elect on behalf of a fund to be subject to the additional provisions described below, notwithstanding any contrary provision in the charter or bylaws.

(a) Fixing Number of Directors and Filling Vacancies. The power to fix the number of directors and the power to fill vacancies on the board are often – but not always – conferred on the board in the bylaws. If so, and if the board has the exclusive power to amend the bylaws (as is permitted in Maryland but not in Delaware), then no further action in this regard is necessary. However, if the charter gives to stockholders the power to fix the number of directors or to fill vacancies, or if these powers are given to the board in the bylaws but the stockholders have the power to amend the bylaws, then the board may want to elect for the fund to opt in to provisions of Subtitle 8 conferring on the board the exclusive powers to set the number of directors and to fill vacancies. Moreover, electing to be subject to the Subtitle 8

provisions relating to filling vacancies has an added benefit for classified boards: Any director elected to fill a vacancy under Subtitle 8 will hold office for the full remainder of the term of the class of directors to which he or she was elected, instead of holding office only until the next annual meeting of stockholders.

(b) Removal of Directors. Under the MGCL, the stockholders may remove any director, with or without cause (unless, as noted above, the director is a member of a classified board), by the affirmative vote of a majority of all the votes entitled to be cast generally in the election of directors. However, the charter may increase this percentage. Some charters of closed-end funds provide for a supermajority vote to remove directors, but others do not. If there is not already a supermajority vote required in the charter, the board of directors may want to consider electing on behalf of the fund to be subject to applicable provisions of Subtitle 8 increasing the vote required to remove a director to two-thirds of all the votes entitled to be cast generally in the election of directors.

3. Director Qualification Bylaws. The MGCL provides: "Each director of a corporation shall have the qualifications required by the charter or bylaws of the corporation." We developed what we believe to be the first fund-specific director qualification bylaws for several closed-end funds. Carefully drafted, director qualification bylaws can aid in ensuring that directors have the requisite background and expertise to act in the best interests of the fund and not any one stockholder or group of stockholders.

4. Increased Voting Requirement for Election of Directors. The MGCL provides: "Unless the charter or bylaws provide otherwise, a plurality of all the votes cast at a meeting at which a quorum is present is sufficient to elect a director." Historically, most bylaws of publicly traded companies provided that directors are elected by a plurality of all votes cast in the election. Increasing the required vote to elect directors to a majority of all the votes entitled to be cast can be an effective defense against a slate of nominees proposed by a dissident with a large position in a fund. Many closed-end funds formed in recent years have included such a provision.[2] However, a majority standard (whether majority of votes entitled to be cast or a variant of majority of votes cast) for the election of directors may make it more difficult to defend against a withhold-the-vote campaign as to incumbent directors (and any non-incumbent management nominees), even in an otherwise uncontested election. Under the MGCL, if directors are not elected, the incumbent directors generally hold over until their successors are elected and qualify (which usually means the next annual meeting of stockholders). In recent years, institutional stockholders, RiskMetrics and other proxy advisors have pressured many public companies to adopt some form of "majority voting" in uncontested elections, coupled with a director resignation policy in the event that a director does not receive the requisite number of votes. The director resignation policy is intended to avoid the possibility of holdover directors.

[2] Note that amended NYSE Rule 452, effective for director elections on or after January 1, 2010, exempts *registered* closed-end funds from the new limitation on discretionary voting by brokers in uncontested director elections, but not closed-end funds that are business development companies.

As a related matter, Section 3-413(a)(2) of the MGCL currently permits one or more stockholders entitled to cast at least 25% of all the votes entitled to be cast in the election of directors to petition a court of equity to dissolve the corporation on the ground that the "stockholders are so divided that directors cannot be elected." Section 3-413(b)(1) extends the same right to any stockholder entitled to vote in the election of directors if the stockholders "have failed, for a period which includes two successive annual meeting dates, to elect successors to directors whose terms would have expired on the election and qualification of their successors . . . ." Stockholders of closed-end funds have attempted to take advantage of Section 3-413, including by soliciting proxies in order to prevent a quorum – thus frustrating the ability of stockholders to elect directors – and then petitioning (or threatening to petition) for dissolution. As we recently reported, the Governor of Maryland has signed legislation, effective June 1, amending Section 3-413 to exclude corporations with a class of equity securities registered under the Securities Exchange Act of 1934 from subsections (a) and (b).

5. Supermajority Board Vote Requirements. The MGCL provides that the board acts by the vote of a majority of directors present at a meeting at which there is a quorum, unless "the charter or bylaws provide for a greater proportion . . . ." To limit the power of a classified board of directors in which the insurgents have won two successive elections, the charter or bylaws may provide for a vote requirement in excess of two-thirds of the number of directors in order to approve various actions (*e.g.*, election and removal of officers, appointment of committees, recommendation of extraordinary corporate action to the stockholders).

6. Advance Notice of Stockholder Proposals. The MGCL specifically authorizes the charter or bylaws of a Maryland corporation to require stockholders to provide advance notice of nominations for directors and other proposals for business. Advance notice bylaw provisions have proven to be an effective means of permitting a corporation sufficient time to evaluate stockholder nominations and proposals. Typically included in advance notice provisions are requirements for submission of various information about the proponent and the proposed nominee or other business. The bylaws of most of our closed-end fund clients have advance notice provisions. In the past three years, we have developed provisions to enhance the efficacy of advance notice provisions by adding disclosure requirements regarding hedging activities by stockholder proponents and persons associated with them in order to give the board and stockholders more information about whether the economic interests of these persons are aligned with the economic interests of other stockholders. These provisions have now been broadly adopted. In a report issued in April, 2009, RiskMetrics Group stated that: "Hedging and derivative disclosure requirements in advance notice bylaws provide useful information to management." We have also added information verification requirements. Closed-end funds that do not have advance notice bylaw provisions may want to consider adopting them and closed-end funds with existing advance notice bylaw provisions may want to consider updating and further enhancing them.

7. Conduct of Stockholders Meetings. As stockholders meetings involving contested nominations or proposals are becoming more common, it is important for the chair of the meeting to have the necessary and appropriate powers to conduct the meeting. We have developed bylaw provisions authorizing the chair to establish procedures for the conduct of the meeting and to take various actions in his or her discretion. In particular, we suggest that boards consider giving the chair of the meeting the explicit power to recess or adjourn the meeting to a later time. It is also important that the bylaw provision on inspectors be both comprehensive in its coverage and specific in its direction to the inspector.

8. Request Requirement for Calling Special Stockholders Meeting; Subtitle 8 Opt-In. The MGCL requires the secretary of a Maryland corporation to call a special meeting of stockholders upon the request of the holders of shares entitled to cast at least 25% of the votes entitled to be cast at the meeting. However, the MGCL permits the 25% requirement to be increased to as high as a majority in the charter or bylaws. Most of our closed-end fund clients have amended their bylaws to permit a special meeting of stockholders to be called by the board of directors or specified officers or upon the request of holders of shares entitled to cast at least a majority of all the votes entitled to be cast at the meeting. If the board does not have the sole control of the bylaws, the board may want to elect for the fund to opt in to a provision of Subtitle 8 raising the requirement for stockholders to call a special meeting of stockholders to a majority of all the votes entitled to be cast at such meeting. This provision will allow a fund to avoid the time, cost and distraction of holding a special meeting if it is not clear that the requesting stockholders will be able to attain a quorum or take action.

9. Procedures for Stockholder-Requested Special Meetings. The MGCL expressly provides that the board of a Maryland corporation has the sole power to establish procedures for a stockholder-requested special meeting, including (a) the record date for the request, (b) the record date for the meeting and (c) the date, time and place of the meeting. We have developed a form of bylaw that establishes requirements for the stockholders' written request (*e.g.*, record date for the request, purpose of the meeting, names and addresses of requesting stockholders) and other procedures for calling and holding a stockholder-requested special meeting (*e.g.*, date, time, place, record date, costs of notice, inspectors of election).

10. Opt-In to Control Share Acquisition Act. A registered closed-end fund incorporated in Maryland may opt in, by board resolution, to the Maryland Control Share Acquisition Act (the "Control Share Act").[3] Generally, the Control Share Act provides that the

[3] A registered closed-end fund incorporated in Maryland may also opt in to the Maryland Business Combination Act and do so by board action alone. Nevertheless, opting in to the Business Combination Act is unlikely to be particularly helpful to closed-end funds, as we are not aware of any attackers of closed-end funds subsequently seeking to engage in any of the types of squeeze-out and other self-dealing transactions defined as a "business combination" in the Act.

holder of control shares of a Maryland corporation acquired in a control share acquisition may not exercise voting rights with respect to control shares except to the extent approved by a vote of two-thirds of all the votes entitled to be cast on the matter, not including votes entitled to be cast by the person who has made or proposes to make a control share acquisition (the "acquiring person") or by officers or employee-directors of the corporation. Control shares are voting shares of stock which, if aggregated with all other shares of stock owned by the acquiring person or as to which the acquiring person is able to exercise or direct the exercise of voting power (except solely by virtue of a revocable proxy), would entitle the acquiring person to exercise voting power in electing directors within one of the following ranges of voting power: (a) one-tenth or more but less than one-third, (b) one-third or more but less than a majority, or (c) a majority or more of all voting power.

An acquiring person may compel the board of directors of the corporation to call a special meeting of stockholders to be held within 50 days of demand to consider the voting rights of the shares. The right to compel the calling of the special meeting is subject to satisfying certain conditions, including an undertaking by the acquiring person to pay the expenses of the meeting.

Section 18(i) of the 1940 Act provides that each share of stock shall be voting stock and have equal voting rights (subject to specific class voting rights relating to preferred stock). The Control Share Act does not, however, affect the voting rights of the shares themselves. Moreover, each holder would, if the fund opted in to the Act, be equally subject to the Act. We are not aware of any judicial decision or published Securities and Exchange Commission interpretation suggesting that Section 18(i) preempts the Control Share Act. Moreover, the Supreme Court has upheld the constitutionality of the Indiana Control Share Acquisition Act, which is substantially similar to the Maryland statute, in an opinion in which Justice Powell declared: "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders." *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 89 (1987). Nevertheless, the Division of Investment Management has persisted in the position in comment letters and otherwise that the Control Share Act is inconsistent with Section 18(i). The SEC has also informally rejected the suggestion that the election to be subject to the Control Share Act could be limited by making an opt-in to the Act inapplicable to any action required by the 1940 Act to be approved by a majority of the outstanding voting securities (as defined by the 1940 Act).

For the more than two decades since control share acquisition statutes were first enacted in over 20 states, it has been the conventional wisdom among takeover defense lawyers that the disadvantage of permitting an acquiring person an open forum to make its case to the stockholders outweighs the advantage of holding the acquiring person's voting power to below the statutory thresholds. However, closed-end funds have only limited power to adopt provisions such as poison pills to defend against attacks. Therefore, the "open forum" disadvantage of

control share acquisition statutes may now be outweighed by the advantage of limiting the insurgents' exercise of voting rights to ten percent unless they can obtain two-thirds of all the disinterested votes entitled to be cast on the matter. This is particularly true where the fund is faced with possible extinction.

11. Indemnification/Advance for Expenses. Maryland has a very broad director and officer indemnification and advance-of-expenses statute. It is common practice for the bylaws of a Maryland corporation to require it to provide its directors and officers with the maximum indemnification and advance of expenses possible under Maryland law, subject, in the case of closed-end investments companies, to the limitations of the 1940 Act. A broad indemnification and expense advance provision aids directors in taking action in the best interests of the corporation in opposing hostile takeovers by reducing the possibility that a director will personally have to pay an adverse judgment and by absorbing the director's cost of defending litigation challenging board actions. It may be advisable to review a closed-end fund's charter and bylaws to determine whether the provisions relating to indemnification and advance of expenses are current and, if not, what actions may be taken to obtain the broadest indemnification and advance of expenses available under Maryland law. We have also developed a Maryland-specific form of indemnification agreement for directors and officers.

PROTECTING NEW CLOSED-END FUNDS

1. Inclusion of Protections in Original Charter and Bylaws. While stockholders take their shares subject to the charter and bylaws, it is generally well accepted that, especially in a suit for equitable relief – *e.g.*, to deny enforcement of a bylaw – provisions that have been in a corporation's charter or bylaws since inception are especially likely to be upheld. Thus, we urge the incorporators and initial directors of a closed-end fund to carefully consider inclusion of adequate protective measures, such as those discussed above, prior to the fund's initial public offering.

2. Long-Term Investment Vehicle. We suggest consideration be given to including in the charter a provision explicitly stating, if consistent with the fund's investment objectives, that the fund is designed as a long-term investment vehicle and authorizing and directing the board of directors to take any and all lawful action to protect the existence of the fund against any efforts that would be likely to result in the termination or significant reduction in the size of the fund.

3. Exclusive Board Control of Bylaws. As indicated above, Maryland law permits the board to be given the exclusive power to amend, alter and repeal the bylaws. Board control of the bylaws is critical to the adoption and maintenance of many of the measures discussed above.

4. Supermajority Stockholder Vote Requirements. The charter may require supermajority stockholder votes for certain extraordinary corporate actions, such as conversion

to an open-end company or dissolution, unless approved by a supermajority vote of the directors or by a specified percentage of continuing directors.

5. Cause for Director Removal. The MGCL authorizes the charter to require cause for the removal of directors. Cause is often defined in the charter.

6. Stockholders Subject to Charter and Bylaws. Although stockholders take and hold their stock subject to the terms of the charter and bylaws, an express statement to this effect in the charter re-enforces and emphasizes the point, especially in the event of litigation.

7. Exculpation from Monetary Liability. The MGCL authorizes the charter of a Maryland corporation to eliminate the liability of directors and officers of a Maryland corporation for money damages in suits by or on behalf of the corporation or by its stockholders, except for (a) actual receipt of an improper benefit or profit in money, property or services or (b) active and deliberate dishonesty established by a final judgment as being material to the cause of action. A broad liability exculpation provision aids directors in taking action in the best interests of the corporation and in opposing hostile action by reducing the possibility that directors will be held monetarily liable for their actions, if challenged. Accordingly, the charter should provide for the maximum possible limitation of liability for directors and officers under Maryland law, subject to the provisions of the 1940 Act.

8. Other Measures. Each closed-end fund is a unique vehicle with its own investment objective, adviser and other characteristics. The circumstances and challenges facing funds change. We have developed other fund- and situation-specific measures, designed to protect the existence of closed-end funds, for consideration in particular circumstances.

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We would be happy to discuss any questions or comments you may have with respect to any of the foregoing information. One or more of the provisions above may be affected by currently proposed or future federal legislation. We caution that any of the foregoing actions should be adopted only after careful deliberation by a fully informed and well advised board. Later this month, after its expected signing by the Governor, we shall be sending a memo on a 2010 bill enacting comprehensive changes to the Maryland Business Trust Act.

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