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Protections In Delaware Law Could Change Activist Investing

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Kenneth Burdon, an attorney in the investment management group at Skadden, Arps, Slate, Meagher & Flom. Read the Q&A below as Kenneth says the new "control share" statute enacted at the start of August by the state of Delaware should protect investors from activist investors acting like corporate raiders trying to force a pop to net asset value without regard to what the broad group of shareholders is interested in. The law forces further negotiation between the board and outsiders, Burdon says, giving directors cards to play when activists come to the table.

Kenneth Burdon

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Kenneth Burdon from the investment management group at Skadden, Arps, Slate, Meagher & Flom is here, and we're talking about how Delaware just changed some rules to protect closed-end fund investors, welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we are looking in the direction of Delaware, where they just, at the end of July, enacted some protections for closed-end fund investors. Here to discuss what that means, Kenneth Burdon, counsel at the investment management group for Skadden Arps. Most people know the firm just from that, but if you want to get more information, well, online it's just Skadden.com. If you want to learn more about investing in closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. Kenneth Burdon, thanks for joining me on The NAVigator.

KENNETH BURDON: Thanks for having me, Chuck. It's a pleasure to be here.

CHUCK JAFFE: Ken, I don't want to get too bogged down in the jargon, but we have to explain what the control share statute, which was what Delaware was working on, what it is, and what it does, and why we as closed-end fund shareholders and investors might feel we are better protected now than we were before this passed.

KENNETH BURDON: Sure, absolutely, and thanks again for having me. And before I get going, I just want to be clear that what I say today are my views, they're my own, they're not necessarily those of Skadden or any of its clients. So this control share statute, it became effective on August 1st, 2022, it automatically applies to any listed closed-end fund or BDC that's organized as a Delaware Statutory Trust. Many closed-end funds are organized at Delaware Statutory Trusts in addition to Maryland Corporations and Massachusetts Business Trusts, this applies to Delaware Statutory Trusts. So what does a control statute do? It says that shareholders acquiring shares above a specified threshold must obtain approval from non-interested shareholders to vote shares that they own above that threshold. Just to unpack a little bit of what's in there in a very simple manner, holdings as of August 1st are grandfathered, so anything that somebody held on August 1st isn't a control share, it can be voted without any extra bells and whistles. I said that non-interested shareholders have to approve voting shares above the control share threshold, a non-interested shareholder is generally anybody other than the corporate insiders and the acquiring person and their associates. And the thresholds here start at 10% with reapproval required at every 5% increment up to 30%, and then a final approval required for a majority. So what that means is that if I acquire shares of a closed-end fund and it puts me at, call it 12%, I can only vote up to 9.99% of my shares until I get approval from non-interested shareholders to vote the rest of that position. And then you have to repeat that at every level, at 15%, 20%, 25%, 30%, and a majority. And in order to get there, the acquiring person and its associate holdings are aggregated, so this includes associates of the acquiring person include people under common control with the acquiring person, other funds with the same investment advisor, and things of that nature. One other thing to understand is that the board is also entitled but not obligated to accept control share acquisitions, either in advance or retroactively, and that's a basic description of the Delaware statute. Maryland also has a statute which is older and is a little bit different.

CHUCK JAFFE: And we should point out, it's well known that Delaware is where the vast majority of US corporations are headquartered. It is also where a majority, I believe, of closed-end funds are based because of the laws there that are very favorable to companies organizing. Now the question is, this is considered a consumer protection, but there are some investors in closed-end funds who might argue that this is not a protection that they want. When I say that, that's because the parties that we're talking about, there's another name for them; activist investors. And an activist investor typically gets involved and says, "Hey, this fund, it's trading at a massive discount. If we can get it to trade just at net asset value, we can make a nice profit." As a shareholder, not controlling anything but just along for the ride, the average investor might like that. They might be very happy to see a closed-end fund convert into an open-end fund and, hey, it pops back up to net asset value and I get a profit. So while this is considered protective, is it entirely protective or is there a downside to it? This could discourage activist investors, or potentially it could make them better organized, right?

KENNETH BURDON: I think that what this does is it creates a situation where the long-term investors in closed-end funds are protected, and I'll explain that. So what are closed-end funds? They're fundamentally investment accounts with an entity wrapper, and that wrapper allows most of your closed end fund investors to get exposures and diversification that they might not be able to get in another wrapper, such as a separately managed account. For example, they might be able to get leveraged returns, they might be able to get exposure to illiquid asset classes that have historically outperformed, or asset classes where it's not practical to invest as an individual for many retail individuals. In fact, I think you're even starting to see the SEC acknowledge this with its Names Rule proposal, which for all of its faults, does have an interesting recognition in it that there are investors who choose certain funds for their own purposes, and that frustrating investors' objectives by changing that fund is a bad thing. So then how does that tie to the control shares statute? Let's go back to the genesis of control shares statutes? As a brief history lesson, they were generally enacted in the 80s as a response to corporate raiders destroying shareholder value for their own personal gain. The objective was not to stop the raider, but to force the raider to negotiate with the board so that all shareholders interests were taken into account. Now activism and operating companies have certainly morphed since the 80s, but at base, closed-end fund activism continues in my view to take on the flavor of raiding. Whether the objective be like you described, it was what I would call a short-term liquidity event, that in my view doesn't do anything to benefit other shareholders in the long term. I think we've seen some good research that over the long term, while you might get a short market value pop to net asset value when a tender offer is engaged in, the fund quickly goes back to a discount. The other tactic that we've seen much more of late is simply taking over funds, and changing strategies that investors have chosen for the own purposes, and you see the activist also starting to insert itself as an investment advisor to that fund and take the fee stream fund to fund. So what the control shares statute does is it puts the closed-end fund back on equal footing from a leverage point of view by ensuring that the board is able to negotiate in all investors' interest; and to insure that any changes to the fund the board opposes as not in the best interest to shareholders has actual broad support from shareholders and not just a very vocal minority that is able to take advantage of corporate governance mechanics and frankly closed-end fund shareholder apathy for voting to benefit its own self-interest. So in this respect, my view is that the statute promotes shareholder democracy, and investors who choose whatever fund for whatever purpose ought to celebrate that.

CHUCK JAFFE: It seems like the idea here is not to end activism but to make it that there's better activism. That there's not so much activism for the sake of activism, just doing something to turn a quick profit, but that there's activism with a purpose. Does that make it that we have a higher grade of activism? That people have a really good case if they're bringing it forward?

KENNETH BURDON: I think it will allow further engagement from boards on behalf of the non-active shareholders, let's call them. So instead of being bullied by an activist who's holding all of the cards, a board of directors now has its own cards to hold to say, "Well, hang on, we hear what you're saying but we think this might be a better result. Perhaps we can work together to get to that result. Instead of simply being bullied into whatever it is you are seeking for yourself, what about the other shareholders? What about those who like this strategy? What about those who are looking at this allocation as part of their overall portfolio as opposed to simply an investment in and of itself?" Using those tools, whether they be a control share statute or whether they be some other governance provision that's designed to ensure broad support from the shareholder base for fundamental changes to the investment to come to pass.

CHUCK JAFFE: Ultimately for individual investors, for financial advisors who use closed-end funds, there's nothing here – and I realize you don't give investment advice – that would have you say, "Hey, if you have a choice between two closed-end funds, and otherwise they are completely equal, but one's a Delaware company and one is not, that you can go with Delaware." I mean, it's not a big deciding factor that makes an investment difference to anybody, right?

KENNETH BURDON: No, I don't think it's a big deciding factor that makes an investment difference to someone, except perhaps on the margins. If somebody's really looking for an investment where the risk of having an activist come in and bully a board to my detriment, if somebody is worried about that, and I grant you, it's not the ordinary shareholder who might even think that far. But if I was worried about that, to make sure that I continue to have my investment in the form that I decided to invest in it in, yes, I would look at what type of governance provisions those funds have. And whether they do have the benefits of something like a control share statute to give the board the amount of leverage that it needs in order to continue my investment in the form that I invested.

CHUCK JAFFE: Really interesting stuff. Ken, thanks so much for joining me to talk about. We'll probably talk about it down the line as we see how it all shakes out and gets played out.

KENNETH BURDON: Absolutely. It's been a pleasure, thanks for having me.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance, which is on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Kenneth Burdon, counsel in the investment management group at Skadden, Arps, Slate, Meagher & Flom. Learn more about him and the firm at

Skadden.com and on Twitter @SkaddenArps. The NAVigator podcast is new every Friday, ensure you don't miss anything by following us on your favorite podcast app. And if you like us, leave a review because they really do help. Until next week, happy investing everybody.

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