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A Baker's Dozen—13 Defensive Takeover Measures Available to Closed-End Investment Companies Organized as Delaware Statutory Trusts

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Delaware statutory trusts have become increasingly popular for the organization of investment companies registered under the Investment Company Act of 1940, as amended (1940 Act).[1] In light of recent public discussion with respect to the use of defensive measures by closed-end funds to counteract takeover attempts,[2] this article addresses some of the more common defensive measures that have been adopted by closed-end funds organized as Delaware statutory trusts and the permissibility of such measures under Delaware law.[3] It also highlights some of the differences in the Delaware laws applicable to statutory trusts and laws applicable

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to Delaware corporations. The defensive measures discussed in this article are not the only ones available to Delaware statutory trusts, but simply some of the more common (for example, this article does not address defensive measures, such as shareholder rights plans (so-called "poison pills"), that, though they may be adopted by Delaware statutory trusts, may be of limited use to closed-end funds or have otherwise not been widely adopted by closed-end funds).

Overview of Statutory Regime Governing Statutory Trusts

Generally speaking, the Delaware Statutory Trust Act (DSTA) is one of the most flexible and permissive statutes for the organization of business entities in Delaware, including with respect to defensive measures that a fund may adopt. The DSTA provides a broad framework for the formation and operation of statutory trusts with few mandatory rules and only a skeleton of default or gap-filler rules. It essentially defers to the terms of the governing instrument with respect to most matters, including defensive or antitakeover measures. In fact, as will be discussed below, there are almost no express limits in the DSTA as to the type of provisions a Delaware statutory trust may include in its governing instrument relating to these types of matters, and the DSTA expressly states its policy is to give maximum effect to the principle of freedom of contract and the enforceability of the terms of a governing instrument.[4] Any limits to the types of provisions that can be included in a governing instrument will probably not come from the DSTA, but instead will probably come from federal law, market practice, public policy or exchange rules. This statutory regime is in contrast to the General Corporation Law of the State of Delaware (DGCL), which governs Delaware corporations. The DGCL, like the corporate codes of many other jurisdictions, has express provisions with respect to many of the matters discussed in this article. Many of the provisions include statutorily mandated limits to their modification. In addition to its flexibility with respect to the types of defensive measures that can be implemented, the DSTA expressly allows for the restriction and, in many instances, elimination of the rights of beneficial owners and the duties (including fiduciary duties) and liabilities of trustees of a Delaware statutory trust that would otherwise apply under Delaware law. Fiduciary and liability matters, as well as the availability of indemnification, can all have an influence on the implementation of defensive measures and are briefly discussed herein.

Select Defensive Measures Available to Statutory Trusts

Measures Related to the Composition of the Board of Trustees

Since the board of trustees has ultimate management authority of a fund, if one controls the board one controls the fund. Many of the defensive measures available to statutory trusts used by closed-end funds are aimed at making it difficult for the board composition to change quickly, such as in a hostile takeover situation.

1. *Staggered Board*. Perhaps one of the most common types of defensive measure employed by public companies, including closed-end funds, is the staggered board (also called a classified board). A staggered board is the organization of the board of trustees into classes and providing for each class to serve for staggered multi-year terms such that only a subset of the board stands for election each year. A common structure is the division of the board of trustees into three classes serving staggered three-year terms such that only the members of one of the three classes is up for election in any particular year. Staggered boards have been described as one of the more effective antitakeover measures available to a company.[5] In most jurisdictions, staggered boards are a permitted exception to the general rule that all members of the board must be elected annually. However, the DSTA does not require annual shareholder meetings or even that trustees be elected by shareholders, so a staggered board for a Delaware statutory trust is not an exception to a general rule.[6] In addition, there are no express limitations in the DSTA as to the number of classes of trustees, trustee tenure or any other aspect of the classification of the board. Thus, how the board

of trustees is organized is left to the terms of the governing instrument and is not dictated by statute. This freedom of contract approach is in contrast to the DGCL and the corporate law of most other states. For example, Section 141(d) of the DGCL provides, in relevant part, that a corporation's certificate of incorporation or bylaws may include a provision whereby the board of directors is:

> divided into one, two or three classes; the term of office of those of the first class to expire at the first annual meeting held after such classification becomes effective, of the second class one year thereafter, of the third class two years thereafter; and at each annual election held after such classification becomes effective, directors shall be chosen for a full term, as the case may be, to succeed those whose terms expire.[7]

Accordingly, the DGCL limits a corporation's staggered board to not more than three classes and requires terms of equal length for all respective classes.[8]

2. *Removal of Trustees*. The DGCL and the corporate laws of many other states generally grant to the shareholders of a company the right to remove directors/trustees, with or without cause, upon a specified percentage so voting, thus providing an opportunity for an insurgent to seize control of the board.[9] In contrast, the DSTA contains no provisions granting shareholders the ability to remove trustees.[10] This right may certainly be granted in the governing instrument, but unless it has been granted, shareholders have no express right under the DSTA to remove a trustee. Though arguably nothing needs to be stated in the governing instrument on this point, it would be advisable to make clear in the governing instrument the circumstances, if any, under which trustees may be removed by the shareholders of the fund, as well as the circumstances, if any, under which a trustee may be removed by his or her fellow trustees.[11]

3. *Size of the Board and Filling Vacancies*. To the extent shareholders have the ability to increase the size of the board of trustees and fill vacancies, such actions can be used to gain control of the board of trustees. There are no default rules or limitations in the DSTA as to the size of the board of trustees or with respect to the filling of vacancies. Therefore, the governing instrument may give exclusive authority to the board of trustees in these matters or may provide shareholder rights in this area.[12]

4. *Director Qualification Provisions*. Mandating specific trustee qualifications in the governing instrument has been employed by some funds in order to make electing a slate of trustees by an insurgent shareholder more difficult. The DSTA has no express provisions addressing trustee qualifications or limiting the qualifications that may be imposed by a governing instrument. Similarly, the DGCL authorizes a corporation's certificate of incorporation and bylaws to provide for director qualifications.[13] However, Delaware case law imposes a "reasonableness" test with respect to corporate director qualifications.[14] Given the DSTA's policy to give maximum effect to the principle of freedom of contract and the enforceability of the terms of a governing instrument, it is likely that a Delaware statutory trust would have more flexibility with respect to setting trustee qualifications than may be available to Delaware corporations.

Measures Related to Board of Trustees' Powers

If an insurgent shareholder is not able to control the board of trustees, a shareholder may attempt to take actions directly to exert control. Therefore, identifying which matters are within the exclusive domain of the trustees, as opposed to those matters over which shareholders have ultimate control, may be of significance. In addition, what percentage of the board of trustees is needed to approve various matters can also have significance.

5. *Management Authority of the Board of Trustees*. Unlike the DGCL and the corporate laws of many other states, the DSTA does not have mandatory rules as to the relative sphere of authority of the board of trustees and of the shareholders of the fund (as a default matter, shareholders have virtually no say in the management of a statutory trust). For example, the relative rights of the board of

trustees on the one hand and of the shareholders of the fund on the other with respect to such matters as amending the declaration of trust (or the bylaws), engaging in mergers, consolidations, assets sales or other extraordinary transactions may be fixed by the governing instrument of a closed-end fund. As a result, shareholder rights with respect to these and other matters can be individually tailored to meet the needs of a particular fund and its objectives.

6. *Supermajority Board Vote Requirements*. In addition to authorizing statutory trusts to set in their governing instruments the matters over which the board of trustees has exclusive authority, the DSTA provides no express limits as to what percentage vote of trustees is required to authorize a particular matter.[15] Supermajority voting requirements are sometimes used in combination with a staggered board to attempt to prevent the trustees elected by an insurgent from dictating the fund's decisions with respect to certain extraordinary matters. However, careful consideration needs to be given with respect to how the supermajority requirement is structured, because such a requirement can also have the effect of providing a veto to an insurgent if not properly drafted or not combined with other provisions (such as a "continuing trustee" provision as discussed below). Further, if an insurgent prevails in back-to-back elections (and therefore controls, for example, two-thirds of the board), the remaining members of the board will likely be hesitant to act as blockers in their minority positions, given that the shareholders will have clearly spoken at two consecutive meetings.

7. *Continuing Trustees' Approval Required.* In addition to supermajority voting provisions, some closed-end funds organized as Delaware statutory trusts have included provisions in their governing instrument requiring that for certain extraordinary transactions, in addition to approval by a specified number of board members, approval is required by all or some number of trustees that have a certain number of years' tenure on the board or were nominated by such board of trustee members. Again, there are no express limits in the DSTA as to these types of provisions or similar provisions; in fact, the DSTA makes clear that the governing instrument of a statutory trust may grant or withhold the right to vote on any matter to all or a certain number of trustees.[16]

Measures Related to Shareholders' Voting Rights and Powers

8. *Voting Rights*. Strikingly, there are no matters the DSTA expressly mandates that shareholders of a statutory trust have the right to vote upon, including, as noted above, the election of trustees.[17] The governing instrument for closed-end funds organized as Delaware statutory trusts often limits shareholders' voting rights to those matters mandated by the 1940 Act. In addition, except for certain extraordinary matters discussed below, the DSTA does not provide default rules with respect to the number of votes needed to approve a matter, including the election of trustees (that is, election by plurality vote is not a default rule in the DSTA). Thus, the governing instrument may set the voting threshold for any matter, including providing for a majority standard (or other standard) for the election of trustees, which can make it difficult to elect non-management-endorsed trustee nominees (though there can be downsides for the inclusion of such a provision). With respect to extraordinary transactions, it is important to note that the DSTA provides default rules for the approval by shareholders and trustees of mergers, consolidations, conversions and transfers or domestication to another jurisdiction: in each case, the default requirement is approval by 100 percent of the trustees and shareholders. These statutory defaults can be freely reduced or eliminated by the governing instrument, but obviously can be a trap for the unwary.[18]

9. *Shareholder Meetings*. As noted above, the DSTA does not require shareholder meetings, annual or otherwise, to be held and provides maximum flexibility with respect to the conduct of such meetings. Importantly, the DSTA does not have default rules with respect to matters such as quorums, adjournments, the ability of shareholders to call meetings, shareholder proposals, and other matters related to shareholder meetings. All of these matters can be tailored to assist in providing defense of management. Of perhaps most significance,

there is maximum flexibility with respect to how difficult or easy it is for a shareholder or a specified percentage of shareholders to call a special shareholders meeting (if indeed that right is granted in the first instance) as well as to who controls (the board or the shareholders) the procedures for holding such a meeting. By comparison, while the DGCL affords flexibility for the certificate of incorporation or bylaws of a Delaware corporation to set forth whether and in what circumstances stockholders may call special meetings of stockholders,[19] a corporation is obligated to hold an annual meeting of stockholders (or the stockholders may force the corporation to do so if one has not been held in 13 months),[20] certain minimum requirements exist with respect to the establishment of a quorum at a stockholder meeting (no less than one-third of the shares entitled to vote),[21] and certain parameters exist relating to adjournment of stockholder meetings (for example, notice requirements if the adjournment exceeds 30 days).[22]

10. *Shareholder Proposals*. Under the DGCL it is generally accepted that stockholders of a Delaware corporation have a right, at least in certain circumstances, to present a proposal at an annual meeting of stockholders for consideration by all the stockholders. However, though no Delaware court has decided the matter, it is unlikely that under the DSTA shareholders have an inherent right to bring proposals. This is because the DSTA generally preserves, as a default matter, the historic approach of trust law that beneficiaries have no right to vote, call meetings or otherwise be heard. Thus, under the DSTA, shareholders likely have the right to bring a proposal at a meeting only to the extent that the governing instrument grants such a right. However, in practice and in light of the federal proxy rules that seem to assume that such a right exists under state law, most closed-end funds have either formally acknowledged the right of a shareholder to bring a proposal or have not challenged proposals that have in fact been submitted. Many closed-end funds have instead followed the approach of Delaware corporations by adopting advance notice bylaws that impose time and other limits upon the submission of shareholder proposals.

While advance notice provisions vary from corporation to corporation, many advance notice provisions for Delaware corporations provide for a 30-day window (typically tied to the period that is 60 to 90 days, or 90 to 120 days, in advance of the anniversary of the prior year's annual meeting) in which stockholders seeking to nominate directors or propose business must provide notice to the corporation of their intention to present such business or nomination. Such provisions typically require stockholders to include certain information about themselves, their ownership interest, the nominees and/or the proposals (as applicable), and impose certain other requirements.

Miscellaneous Matters

11. *Share Acquisition and Controlling Shareholder Provisions*. Many state corporation laws, including Delaware's, have statutory provisions that are designed to limit the actions of a stockholder who purchases a large block of shares without prior board approval. For example, Section 203 of the DGCL generally prohibits a public Delaware corporation from engaging in any "business combination" with any "interested stockholder" for a period of three years following the time that such stockholder becomes an interested stockholder, unless the board of directors approved in advance the business combination or transaction that resulted in the stockholder becoming an "interested stockholder" or, following such time, the business combination is approved by the board of directors of the corporation and authorized at an annual or special meeting of stockholders by the affirmative vote of at least two-thirds of the outstanding voting stock that is not owned by the interested stockholder.[23] An "interested stockholder" is generally defined to include any entity or person beneficially owning 15 percent or more of the outstanding voting stock of the corporation, as well as any entity or person affiliated with or controlling such entity or person.[24] A "business combination" is broadly defined to generally include mergers, asset sales, stock issuances and other transactions providing a financial benefit to the interested stockholder. Although the DSTA has no similar provisions,

in furtherance of its freedom of contract principles, it would permit a statutory trust to achieve the same protections through the terms of its governing instrument. Given that insurgent shareholders of closed-end funds have not historically engaged in the types of transactions for which Section 203 of the DGCL provides protection, it is important to note that a Delaware statutory trust would not be limited to mimicking the provisions of that section. A statutory trust would have considerable freedom to formulate other protections, including approximating the provisions of controlling shareholder regimes available in other states (Maryland's Control Share Acquisition Act, for example).

12. *Delaware as Exclusive Forum*. An emerging area of the law relates to efforts to limit litigation of certain disputes to a specified forum. While limiting the forum where disputes may be litigated is not, strictly speaking, defensive in nature, such a provision can assist in providing greater certainty and predictability with respect to defensive actions taken by an entity and the enforceability of provisions found in its governing documents. The Delaware Court of Chancery recently suggested, *in dicta*, that a Delaware corporation could mandate in its certificate of incorporation a particular forum for state-law-based, intra-entity disputes.[25] Although the matter is still somewhat uncertain, Delaware corporations may be able to designate the Delaware Court of Chancery in their certificates of incorporation or bylaws as the exclusive forum for such disputes. Delaware statutory trusts are explicitly permitted under Section 3804(e) of the DSTA to include provisions in their governing instruments providing for the exclusive jurisdiction of Delaware courts.[26]

13. *Fiduciary Duties, Liability and Indemnification/Advancement*. The adoption (particularly for funds with an operating history) and use of defensive measures often raise questions as to the fiduciary responsibilities of the board of trustees and the potential personal liability of trustees. While treating these topics in detail is beyond the scope of this article, it is important to note that the fiduciary duties of trustees of a statutory trust (and liability for breach of those duties) are expressly permitted by the DSTA to be expanded, restricted or even eliminated (subject to a floor set forth in the DSTA), and many closed-end funds have used this flexibility to provide their boards with greater protection than may be available under the DGCL or the laws of other jurisdictions.[27] In addition, the DSTA permits the indemnification of trustees and the advancement of related expenses without any express limitations, although some public policy limitations for certain types of misconduct may still apply.

Conclusion

The flexibility of the DSTA and its policy of giving maximum effect to the principle of freedom of contract provide closed-end funds a variety of options when the board of trustees is contemplating adopting defensive measures. This flexibility is in contrast to the approaches of many statutes governing corporations, which tend to be more restrictive and/or do not permit the overriding of statutory provisions. The authors believe that the flexibility to adopt these defensive measures under the DSTA make a Delaware statutory trust the preeminent choice for the formation of closed-end funds in the United States.

Notes

1. J. Weston Peterson, "Investment Companies Organized as Delaware Statutory Trusts: Practical Considerations for Drafting Governing Instruments," *The Investment Lawyer*, Vol.15, No.1 (Jan. 2008).

2. *See, e.g.*, Andrew J. Donohoe, Director of the Division of Investment Management of the Securities and Exchange Commission, "Keynote Address at the Independent Directors Council Investment Company Directors Conference," available at *http://www.sec.gov/news/speech/2009/spch111209ajd.htm*, where Mr. Donohoe raised questions about whether the use of certain defensive measures by a closed-end fund would be in the best interest of the fund and its shareholders. *See also* the May 2010 issue of *The Business Lawyer* which includes discussions with respect to the constitutionality of Delaware's antitakeover statute applicable to Delaware corporations. *See,* Guhan Subrahamian, Steven Herscovici & Brian Barbetta, "Is Delaware's Antitakeover Statute Unconstitutional?," 65 *Bus. Law*. 685 (2010); Eileen T. Nugent, "A Timely Look at DGCL Section 203," 65 *Bus. Law.* 753 (2010); A. Gilchrist Sparks III & Helen Bowers, "After Twenty-Two Years, Section 203 of the Delaware General Corporation Law Continues

to Give Hostile Bidders a Meaningful Opportunity for Success," *65 Bus. Law.* 761 (2010); Stephen P. Lamb & Jeffrey Gorris, "A Practical Response to a Hypothetical Analysis of Section 203's Constitutionality," 65 *Bus. Law.* 771 (2010); Gregg A. Jarrel, "A Trip Down Memory Lane: Reflections on Section 203; Larry E. Ribstein, "Preemption as Micromanagement," 65 *Bus. Law.* 789 (2010); Guhan Subrahamian, Steven Herscovici & Brian Barbetta, "Is Delaware's Antitakeover Statute Unconstitutional? Further Analysis and a Reply to Symposium Participants," 65 *Bus. Law.* 799 (2010).

3. This article does not address the permissibility of defensive measures under the 1940 Act or other non-Delaware law.

4. *See* 12 Del. C. § 3825(b).

5. *See, e.g.,* Lucian Arye Bebchuk, John C. IV Coates & Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," 54 *Stanford Law Review,* 887 (2001-2002).

6. Unlike the DGCL, the ability to elect and remove management is not a fundamental underpinning of the DSTA. The DSTA evolved from the law of traditional common law trusts where, particularly in gift scenarios, trustees generally control all aspects of trust property and are not appointed by beneficiaries or subject to replacement by them absent extraordinary circumstances.

7. 8 Del. C. § 141(d).

8. *See id.*

9. *See* Section 141(k) of the DGCL, which provides, subject to certain exceptions, that "any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors."

10. 12 Del. C. § 3303(a) provides, however, that a fiduciary is always subject to removal by a court of competent jurisdiction for willful misconduct, which is defined as "intentional wrongdoing, not mere negligence, gross negligence or recklessness."

11. By contrast, directors of a Delaware corporation lack the power to remove fellow directors. *See* Kurz v. Holbrook, 989 A.2d 141, 157 (Del. Ch. 2010) ("For 89 years, Delaware law has barred directors from removing other directors."), *aff'd in part, rev'd in part on other grounds sub nom.* Crown EMAK Partners, LLC v. Kurz, 992 A.2d 377 (Del. 2010).

12. This is similar to the rules applicable to Delaware corporations. With respect to setting the size of the board, the DGCL provides that the number of directors shall be fixed "by, or in the manner provided in, the bylaws" unless the certificate of incorporation fixes the number of directors. *See* 8 Del. C. § 141(b). With respect to the filling of vacancies and newly created directorships, Section 223 of the DGCL generally provides that, unless otherwise provided in the certificate of incorporation or bylaws, such vacancies or newly created directorships may be filled by a majority of the directors then in office. *See* 8 Del. C. § 223(a)(1). Accordingly, the DGCL provides flexibility for corporations to provide exclusive discretion to the board of directors with respect to such matters in the governing documents, and it is not uncommon for the governing documents of a Delaware corporation to limit such matters to the exclusive province of the board.

13. *See* 8 Del. C. § 141(b) (providing that "Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors.").

14. *See Kurz,* 989 A.2d at 157 ("Section 141(b)'s recognition of the bylaws as a locus for director qualifications instead contemplates reasonable qualifications to be applied at the front end, before a director's term commences, when the director is 'elected and qualified.'").

15. The DGCL sets a statutory default that the approval of a majority of the directors present at a meeting at which a quorum is present shall constitute board approval, but permits the certificate of incorporation or bylaws of a corporation to modify this standard. *See* 8 Del. C. § 141(b). Similarly, 12 Del. C. § 3323(a) provides a statutory default that any power vested in three or more trustees may be exercised by a majority of such trustees unless the governing instrument provides otherwise.

16. Under the DGCL, if directors are to have different voting rights, such differences must be set forth in a corporation's certificate of incorporation. *See* 8 Del. C. § 141(d).

17. Note that, though perhaps not a voting right, at least one shareholder approval matter set forth in the DSTA cannot be altered or eliminated in the governing instrument: revocation of dissolution of a statutory trust must be approved by all remaining shareholders. *See* 12 Del. C. § 3808(c).

18. By contrast, the DGCL provides various categories of transactions as to which stockholder approval is generally required (in addition to the election of directors), including an amendment to the corporation's certificate of incorporation, merger, conversion of the corporation, sale of all or substantially all of the corporation's assets, and dissolution. *See* 8 Del. C. §§ 242, 251, 266, 271 and 275.

19. *See id.* § 211(d).

20. *See id.* § 211(c).

21. *See id.* § 216.

22. *See id.* § 222(c).

23. *See id.* § 203(b)(4). Note that Section 203 of the DGCL only applies (as a default matter) to Delaware corporations with a class of stock listed on a national securities exchange or held of record by more than 2,000 stockholders.

24. *See id.* § 203(c)(5).

25. In re Revlon, Inc. Shareholders Litig., 2010 WL 935626 at *19, n. 8 (Del. Ch. Mar. 16, 2010).

26. *See* 12 Del. C. § 3804(e).

27. The DGCL contains no provision which permits the modification or elimination of fiduciary duties. However, Section 102(b)(7) of the DGCL permits a corporation to include a provision in its certificate of incorporation which eliminates or limits the personal liability of directors to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, subject to certain important limitations, such as a breach of duty of loyalty or action taken in bad faith. *See* 8 Del. C. § 102(b)(7).

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