A Battle Over Closed-End Activism Is Now Awaiting A Supreme Court Decision

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Chuck Jaffe, in this episode of The NAVigator podcast interviews Kenneth Burdon, an attorney with Simpson Thacher and Bartlett. Kenneth, discusses the court case between Saba Capital and four closed-end fund sponsors that has wound its way to the U.S. Supreme Court and that is expected to force a change in the tactics of the industry's most prominent activist investor or in the way management companies protect themselves against aggressive shareholder actions. Saba challenged the four companies' actions in adopting a Maryland law that makes it more difficult for outside investors to gain control through a proxy fight. Burdon says Saba is the only company to challenge closed-end fund governance in federal court, and that the company could lose that tactic without significantly reducing its ability to pursue activist actions, just taking more common and traditional tactics used by others. Burdon says, based on precedents, that he expects the decision to come down in favor of the fund sponsors.

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

CHUCK JAFFE: Attorney Kenneth Burdon of Simpson Thacher and Bartlett is here, and you're about to learn about a court case involving closed-end funds that could impact you and that is at the Supreme Court, this is The NAVigator. Welcome to 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, which is a unique industry organization representing the full spectrum of the closed-end fund business from investors and users to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we are looking in the direction of a future Supreme Court case that will impact how activist investors are allowed to pursue litigation against closed-end funds, that also means it's going to impact how you might benefit or be impacted by what activist investors are doing next. We're having this discussion with Kenneth Burdon, he's an attorney with Simpson Thacher and Bartlett, you can learn more about Ken at STBLaw.com, but if you want the firm's write-up on the case and where things stand now, look for the link in our show notes. And if you want more generally about closed-end funds, interval funds, and business-development companies, go to AICAlliance.org, that's the website for the Active Investment Company Alliance. Ken Burdon, welcome back to The NAVigator.

KENNETH BURDON: Thank you, Chuck. It's great to be back again, thanks for having me on.

CHUCK JAFFE: This is a case where it would be easy for us to get bogged down in the legalese, but let's see if I can give a little bit of the background and then you can update us to where things are, because again, a closed-end fund case in the Supreme Court, not your everyday occurrence. But this starts a couple of years ago when Saba Capital, which is a leading activist investor, they filed a lawsuit against a couple of different closed-end fund companies who were adopting a Maryland law that effectively makes it very difficult for an activist investor to take control, it's all about how they're going to have to get a two thirds vote of other shareholders, so in other words, they built up some equity but their equity doesn't count and it makes it much more difficult for an activist investor to do what it does. And Saba, well, Saba is known for looking for closed-end funds that trade at big discounts, where they are coming in and saying, "Hey, if you make changes, share prices are going to go up," and plenty of investors love that kind of thing, let me find a fund that's discounted and then benefit when we wind up seeing the discount narrow, but this is a big fight and it could reshape things. So help us understand, it's at the Supreme Court, which means we still have steps to go before it's heard, so, A) did I describe this roughly right? And then, B) where exactly is this case now and how is it moving forward?

KENNETH BURDON: Yeah, thanks. Yes, that is roughly correct. So what's happened so far is that the Supreme Court has decided to take the case, it will be heard during its next term, which starts in October, so hopefully it will be heard for oral argument in October or November, and then hopefully we'll have a decision sometime in the spring of next year. So what happened was Saba sued these closed-end funds under a section of the Investment Company Act called Section 47(b), which says that a contract is unenforceable if it violates the Investment Company Act, but that section of the statute doesn't otherwise provide any, what we call rights-creating language, that explicitly authorizes shareholders to bring a federal lawsuit under that provision. So what you do is you contrast that with another provision of the Investment Company Act, which is Section 36(b), which allows suits for excessive fees, which we've seen ebb and flow over the years, now 36(b) expressly says that shareholders can bring a suit in federal court under 36(b) alleging excessive fees. So what you have here is this question about whether Section 47(b) provides shareholders with a right of action to bring a federal suit when it doesn't expressly say that shareholders can bring that federal suit. This goes back to a separation of powers question, who gets to give private citizens the right to initiate a lawsuit under federal law, which is what we call private right of action, is that Congress or is it judges? The answer from the Supreme Court, based on old precedent cases, is that it's Congress. So the question then becomes, should the judiciary ever imply a private right of action in a statute, like Section 47(b), in the absence of express statutory language creating that private right of action? And then that becomes a question of statutory [intent 0:05:36]. And at least since 2001, there was a almost landmark, I wouldn't call it landmark in the sense of the real big Supreme Court cases, but in this sense it is, the Supreme Court has been much more cautious about implying those private rights of action absent the explicit statutory language authorized in those suits, and that's what people are arguing about here. So the Second Circuit Court of Appeals, which covers New York, has said, "Yes, we think there is a private right of action in Section 47(b)," and that's where Saba sued in this case, in the New York in the Second Circuit in the southern district of New York. But there's also the Third, the Fourth, and the Ninth Circuit Courts of Appeals who have considered this question and they said, "No, we don't think there's a private right of action under Section 47(b)," so here we are at the Supreme Court to essentially get our final answer.

CHUCK JAFFE: How much of a chill could this put on activism? Does it simply make it that activism becomes more difficult, that the bar is raised and that activist investors like Saba would have a more difficult time achieving their objective, or does it put the activists out of business?

KENNETH BURDON: What I think it does is it really just takes away Saba's existing strategy of challenging in federal court closed-end fund governance decisions that have historically before Saba started challenging them were within the board's discretion and within established SEC guidance as to where those decisions could go and what was appropriate and inappropriate under the 1940 Act. So I believe, and the briefs in the Supreme Court assert this, that Saba is the only shareholder to have ever sought and obtained relief under Section 47(b). So kind of holding that there's no private right of action would not choke off any existing or established pipeline of litigation or theories of cases, it would not take away Saba's ability to run proxy contests, it would not take away Saba's ability to challenge boards of directors in state court, but it would take away the current strategy that has been to challenge in federal court, closed-end fund governance decisions that Saba disagrees with.

CHUCK JAFFE: I guess converse to that would be is Saba wins this case, would you expect others to say, "Hey, that clears the lane, I'll join Saba in creating even more pressure when I come in as an activist"?

KENNETH BURDON: So I'm not sure that it would really create a lot of additional activist pressure should Saba win the case, I think the consequences are probably much more consequential. It could conceivably open up an entirely new avenue for federal plaintiffs against investment companies regulated under the 40 Act, it could open up entirely new subject matters to litigate beyond excessive fee cases. And so just to step back, investment companies are operated largely through a collection of contracts, and if plaintiffs have a cause of action to initiate challenges to these contracts for violating any provision of the Investment Company Act, irrespective of how the SEC has viewed the interpretation of that provision, the enforcement of that provision, and what the market practice around that provision has been over the course of 80 years since the Investment Company Act has been in place, it could create a level of chaos, uncertainty in what is a multi-trillion dollar industry, because we're not just talking about closed-end funds, we're talking about mutual funds, we're talking about ETFs, where that goes is hard to quantify, particularly once you've got a

Supreme Court stamp of approval for the cause of action. So as I've alluded to, it's been uncertain really whether this cause of action exists, it's only existed in one of the federal circuits recently. If the Supreme Court says, "Hey, now you've got another cause of action here," the plaintiff's bar within the investment management industry is created and I don't think it's really easy to quantify where that could go, what kind of litigation you might see, and what kind of theories and cases you might see coming forward.

CHUCK JAFFE: Given the proclivities and sensibilities of the Supreme Court at this point, where you have more folks appointed by republican than democrat, you have them appointed by somebody who is very much, "Let's diminish regulation," et cetera, and they have shown some tendencies to try to remove some barriers to just go off and do things, do you have a sense, do you have a leaning, is anybody handicapping how this is likely to turn out?

KENNETH BURDON: I thought you might ask that, Chuck, and I want to step back and say that I'm going to kind of approach it from my, while I'm an investment management lawyer, I might consider myself an amateur constitutional lawyer, but I want to approach it from a little bit of historical observation on the Supreme Court. This case that I referenced where the Supreme Court has reigned in this concept of implying private rights of action, it was a 2001 case, it was a classic Justice Scalia decision, it was five to four with this very heavy textual analysis of the statute in issue. If you look at where the Supreme Court has gone since then, I think now you have at least six justices that would take a similarly textual approach when presented with a question like this. So the interesting thing is that how you interpret the Investment Company Act is not the most politically charged issue of the day, it's going to be kind of interesting to see how the court at large looks at this. If you go back to the Jones v. Harris case, which was the excessive fees case that went up to the Supreme Court quite a while ago, that ended up being a nine to nothing opinion in favor of the sponsor there. So I see some kind of potential for broad consensus here, I would be thrilled to see a nine to zero decision in favor of [inaudible 0:12:17] here, but I could imagine a world where it comes out six to three, and I would kind of frankly be surprised if the current make-up of justices saw this differently just based on that historical textual view of things, and how there is just such an express private right of action in Section 36(b) for excessive fees, at least in my mind it's

hard to square the presence of that with the absence of a private right of action in 47(b) and then continuing to say there is a private right of action under 47(b).

CHUCK JAFFE: It's going to be really interesting to watch how it plays out, and again the impacts could be very wide ranging. Ken, it's been great to chat with you about, thanks for joining me on The NAVigator to discuss it.

KENNETH BURDON: It's been a pleasure, Chuck. Thanks again 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, I'm Chuck Jaffe, I'd love it if you'd check out my hour-long weekday podcast by going to MoneyLifeShow.com or by searching for it wherever you find great podcasts like this one. To learn more about closed-end funds, interval funds, and business-development companies, go to AICAlliance.org, that's the website for the Active Investment Company Alliance. Thanks to my guest Kenneth Burdon, an attorney with Simpson Thacher and Bartlett, learn more about Ken at STBLaw.com, but if you want the firm's extensive write-up on the case we were discussing, look for the link in our show notes in the show's description today. The NAVigator podcast has something new for you every Friday, make sure you never miss an episode subscribing or following along on your favorite podcast app, and if you liked this podcast, leave us a review and tell your friends because that stuff really does help us. We'll be back with more closed-end fund fun next week, and until then, happy investing, everybody.

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