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Meditations in a (Fund) Emergency: Practical Advice for Fund Trustees

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By Aaron Morris

Share:

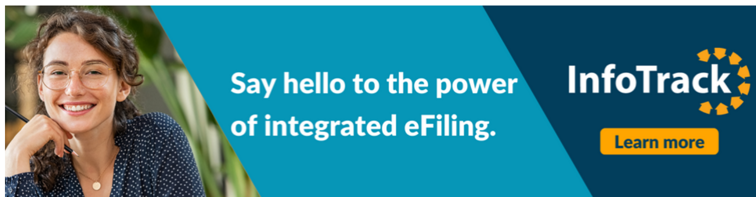
Emergencies don't strike investment companies very often, but when they do (think revelation of internal misconduct, a catastrophic investment loss, or an unexpected regulatory investigation), decisive action is often required of the fund's

trustees, who owe a duty to advance the interests of shareholders. Experience suggests, however, that some boards are missing (or giving away) opportunities to take proactive measures, leaving shareholders worse off and trustees exposed to potential litigation. What's worse, when litigation is filed, trustees too often default to positions that favor the financial interests of the advisor over alternatives that might provide value to shareholders. During and after a crisis, trustees more than ever must be prepared to shift the way they think about the fund's relationships with service providers in order to obtain meaningful results for shareholders (and mitigate or eliminate their own litigation risk). This article provides an example of what not to do and a few practical suggestions.

An Example of a Counterproductive Response

In a now-public example of a board's actions during and following a fund emergency, a closed-end fund with an unsustainable amount of portfolio leverage saw its portfolio eviscerated by roughly 80 percent during a period of heavy volatility in the markets—a loss that deviated significantly from its benchmark and peers. In the aftermath, the trustees declined to take independent formal action to investigate the

losses and informally looked to the advisor to determine what to do. The trustees chose, without the aid of independent analysis or even board minutes or materials documenting their consideration, not to pursue a recovery for the fund. Instead, they hired the advisor for another year and subsequently agreed to a proposal (from the advisor) to merge the fund away through a transaction with a larger closed-end fund. Imagine: a crippling 80 percent loss dismissed by the trustees as not important enough to mention in the minutes! While multiple potential responses to such a crisis may fall within the range of a trustee's business judgment, doing nothing is not one of them: Indifference (or obstinance) does not satisfy the caliber of oversight that shareholders are entitled to expect.



The irony of such a superficial approach is that it works against not only the fund's best interests but also the trustees' own personal interests. The law affords a measure of deference to informed and good-faith decision-making by trustees, but not where trustees fail to create even the appearance of independent action. Trustees who reflexively circle the wagons with an advisor not only may be neglecting the interests of their true

constituents but may be placing *themselves* at risk. By refusing to pursue viable claims, they pave the way not only for litigation generally but for the trustees to be named as defendants (typically with limited indemnification rights).

Practical Advice

Serving as a trustee entails difficult and complex responsibilities, and trustees do an excellent job most of the time for the funds they serve. But they must be prepared to act decisively and deviate from "business as usual" during or after an atypical fund event like an investment loss that threatens the fund's viability, misconduct among service providers, a regulatory action or investigation, a major transaction involving the fund or advisor, or other significant and unexpected events. Through a diligent and formal board process, trustees should be positioned to answer definitively the questions below, which will guide their next steps:

Are shareholders worse off in any way?

An investment loss is perhaps the most obvious potential harm to shareholders, but every circumstance is unique, so trustees may need to think more broadly. Are shareholders realizing

unjustified tax expenses? Have they lost the ability to exit the fund on favorable terms? Have their voting rights been infringed? Have they overpaid for asset-based expenses? Have they missed an opportunity to derive a material benefit or a future material benefit? Advisors and other service providers are compensated for the risks they assume in providing services to the fund, so trustees should think carefully before writing off losses as attributable to investment risk alone. In conducting this analysis and those below, trustees should carefully consider their regular counsel's relationship to the fund's service providers and whether specialized independent counsel may be necessary.

Who are the culpable parties and sources of recovery?

In answering the question above, the board must genuinely consider whether a service provider is responsible and whether compensation is appropriate. Trustees should refrain from papering over losses with artfully drafted board materials because this is unlikely to stand up in litigation. Instead, they should address the issues head-on and consider closely which service providers had relevant responsibilities, who was in the best position to prevent the losses, what insurance coverage is available, and what leverage the board may have to resolve the dispute in favor of shareholders. This may require

considering the trustees' own liability, but the fund and its shareholders pay good money for insurance coverage for precisely such circumstances, and there are governance tools available to boards to properly consider such liability. Trustees should be proactive in this regard rather than waiting for litigation.

What form and amount of relief can be obtained?

Trustees often have beneficial alternatives at their fingertips that would meaningfully address shareholder harm without overly penalizing the responsible parties. For example, are there insurance policies at the fund, advisor, or other provider levels that cover the conduct at issue? Are there responsible personnel or deficient controls that should be replaced at the provider's expense to avoid future mistakes? Should a provider return some portion of previously paid fees or make a cash payment proportionate to the losses? Would permanent or temporary reductions to fees or expenses going forward compensate the fund? If the fund is no longer viable, can the board obtain a merger premium for shareholders? Is there a trading discount that can be addressed to mitigate some of the losses? Are other advisors willing to provide items of value in exchange for the fund's advisory contract? Can the fund partially liquidate while reserving a portion of assets to advance claims

against responsible parties?

Potential responses are, of course, fact-dependent and limited only by the diligence and creativity of the independent trustees. Practice shows, however, that boards too often fail to explore the full range of possibilities, opting instead to paper the record with superficial justifications for the conduct at issue or immaterial benefits for shareholders (many of which appears to be advisor- or counsel-driven). This approach is counterproductive and risky: Trustees do not want to be in a position down the road of defending tenuous rationales dreamed up by other parties. They should own the dialogue, determine what a genuine "get" for shareholders is under the circumstances, and conduct a documented board process intended to capture it.

At bottom, a defensible board process during and after a fund crisis must be rooted in common sense and free from conflict of interest. An advisor's role is to provide competent and fair investment management services, not dictate the board's actions (especially during a crisis of the advisor's own causing). As the ultimate managers of the fund, trustees are responsible for advancing the interests of shareholders when they've been harmed. To do so, a different tack than is typical for everyday governance likely will be required. Trustees who instead play a passive part in an advisor-driven process expose

themselves to scrutiny by shareholders and regulators.

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