How Directors Can Handle Adviser's Exit From Fund Biz

By Jay G. Baris

An investment adviser's decision to exit the fund business can present multiple challenges for the fund board. These challenges can be particularly difficult when the interests of the adviser and those of the fund and its shareholders do not completely align. Here is some practical guidance for fund directors who face this situation.

Assignment of Advisory Agreement

The Investment Company Act of 1940 requires every investment advisory agreement with a registered investment company to terminate automatically in the event of its "assignment." The purpose of this requirement is to prevent investment advisers from "trafficking" in fund advisory contracts. In other words, the statute limits an investment adviser's ability to sell investment advisory relationships for its own benefit, which could violate its fiduciary responsibilities to a fund.

An assignment can occur in several situations. For example, when an adviser seeks to exit the fund business, it may want to sell its advisory contracts to a third party. This simple form of assignment results in automatic termination of the contracts.

An assignment also may occur in the event of a direct or indirect "change of control" of the investment adviser. A direct change of control occurs when 25% or more of the adviser's voting shares changes hands. An indirect change of control occurs when 25% or more of the voting shares of an adviser's direct or indirect parent changes hands. In either case, a change of control results in an assignment that triggers the automatic termination of a fund's investment advisory agreement.

An assignment is usually intentional: An investment adviser, or its parent, desires to sell all or a part of its advisory business, including the part relating to fund management, and it actively seeks a buyer. In this case, the fund's board can establish an appropriate process to evaluate and act when a change of control may occur.

Sometimes, however, the assignment occurs suddenly and unexpectedly. For example, if the principal owner of an investment adviser dies suddenly in an auto accident, the fund investment advisory agreement immediately terminates, and the fund's board must take emergency action to keep the fund up and running. While this scenario may sound far-fetched, it has actually happened.

Conflicts of Interest

When faced with the potential change of control of the fund's adviser, a key task for directors is to identify and understand potential conflicts of interest. For example, the investment adviser's shareholders may be motivated by the desire to obtain the highest value for their shares. This goal is not necessarily entirely consistent with the fund directors' goal of obtaining high-quality advisory services at a fair price.

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In any event, the fund's board must determine if the change of control is in the best interests of the fund and its shareholders. Given competing interests, including in some cases the interests of the fund directors, getting to that point can present challenges. Board members must focus not only on the consequences of approving the transaction, but also the consequences of not approving the transaction.

What should a fund board do when faced with a potential sale of a fund's investment adviser?

First, understand the structure of the proposed transaction.

- Does the purchaser intend to keep the funds intact, or merge the funds into its own structure (if it has one)?
- If the purchaser proposes fund mergers, or reorganizations, would the funds merge into existing funds, or into newly created "shell" funds designed to continue the operations of the existing fund? Would the existing board of directors be asked to stand down?
- Does the purchaser intend to retain the current adviser's portfolio managers, analysts and administrative personnel?

Second, identify potential conflicts of interest.

- What are the financial terms of the proposed transaction, and how much money will the seller realize?
- How did the seller identify potential acquirers?
- What factors did the seller consider when recommending a specific acquirer?
- Will the acquirer commit to honoring existing expense limitations? Does the acquirer intend to raise fees immediately or in the future?

Third, conduct due diligence on the acquirer.

- Ensure that the nature and the quality of the services that the acquirer will provide are comparable to or better than the services currently provided to the funds.

Fourth, understand the costs of the potential transaction.

- Who will pay the costs of the proxy solicitation, special board meetings and fees of other service providers engaged to evaluate the transaction on behalf of the board?
- Will the transaction subject shareholders to an "unfair" burden?
- Are there any tax consequences of the transaction?

Safe Harbor for Investment Advisers

The '40 Act recognizes that, notwithstanding the strong desire to prevent the trafficking of fiduciary duties, the sale of investment advisory businesses is a fact of life. So the law provides investment advisers who sell their business with a "safe harbor." That is, if an investment adviser complies with certain conditions, it will not be liable for breach of fiduciary duty if it sells some or all of its investment advisory business for compensation.

First, investment advisers must agree that the sale of their business will not result in an "unfair burden" on fund shareholders. For example, shareholders should not pay higher fees for investment advisory services going forward, since this could be the economic equivalent of having fund shareholders indirectly compensate the

adviser for selling its business. To comply with this condition, buyers typically agree to cap investment advisory fees—and often other fund expenses—for a defined period of time.

Second, for a period of at least two years, at least 75% of the fund's board must consist of directors who are not "interested persons" of the current adviser or the new investment adviser. This provision is intended to ensure that the dealings with the future adviser remain at arm's length.

Fund Governance

Perhaps the knottiest of all issues is presented when the acquirer of an investment advisory business intends to merge a family of funds into its own fund structure. Often, when an investment adviser sells its business, the acquirer operates a fund complex with its own board of directors and service providers, including accountants, lawyers and administrators. With a view toward achieving operating efficiencies, the adviser may not want a second set of fund directors or service providers.

In these circumstances, the fund's board of directors may be asked to fall on its sword for the greater good of the funds and their shareholders. The challenge is that the fund's board may, in good faith, believe that it is better qualified to protect the shareholders of the existing funds than the board of the acquiring fund. But the acquiring company may not share that view, and may accuse the directors of acting in their own interests.

In this difficult situation, directors must step back and remember that as fiduciaries, they have a duty of care and loyalty to the funds under their stewardship, and that they must put the interests of the funds and their shareholders before their own interests. Independent directors should consult independent legal counsel to ensure that they are fulfilling their fiduciary obligations when considering this issue.

Due Diligence

As noted earlier, fund directors considering a change of control of a fund's advisers should conduct adequate due diligence on the potential acquirer. Directors typically use a Section 15(c)-type process to establish a record document that they were diligent in evaluating the capabilities of the acquirer. Funds often meet with representatives of the acquirer, and, in the case of fund mergers, with the board of directors of the surviving funds.

In some cases, fund boards ask to meet with the adviser's investment banker, if one was used, to learn about the process used to identify and recommend the acquirer. Similarly, to gain assurances that the selection of the acquirer is in the interests of fund shareholders, the fund directors may ask about the bids that the adviser rejected.

Sometimes, fund boards hire outside consultants to help them collect and evaluate these facts, to ensure that the directors are carrying out their fiduciary responsibilities when evaluating a potential transaction.

Alternative Structures

Often, acquirers prefer to "reorganize" funds into a complex that they manage without taking any action related to the ownership of the investment adviser. While this form of transaction functionally is an asset sale rather than a change of control of the adviser, the concerns are the same because the acquirer typically compensates the current adviser for "selling" the right to manage the fund assets.

Fund combinations frequently take the form of “tax-free” reorganizations. That is, the existing fund transfers all of its assets and stated liabilities to an “acquiring” fund, which may be an existing operating fund or a newly formed “shell” fund established to continue the operations of the existing fund.

In exchange for these assets and stated liabilities, the acquiring fund issues new shares in proportion to the amount of each shareholder’s investment in the existing fund. At the end of the day, the shareholder will own a number of shares of the acquiring fund that is equal in value to that of its existing fund holdings. If the funds comply with certain interpretations of the Internal Revenue Code, the transaction will not result in any federal income tax liability to shareholders.

Sometimes the acquiring investment adviser does not want to manage a particular fund of the selling adviser. The selling adviser, faced with managing smaller “orphan” funds, may ask the board of directors to liquidate those funds. In this event, shareholders will be forced to redeem their shares. Directors should be aware that those shareholders may incur significant gains or losses for federal income tax purposes.

In evaluating potential alternatives to a new investment adviser or a fund merger, directors also should consider the consequences of not approving it. For example, while investment advisers owe a fiduciary duty to their clients, we are not aware of any requirement that an adviser be forced to continue to stay in any particular business. The consequences of not approving a proposed transaction can be costly and detrimental to shareholders, and could require the fund’s directors to take on the responsibility for managing a fund themselves—a result few directors bargain for.

Interim Investment Advisory Agreements

Section 15(a) requires that fund shareholders approve any new investment advisory agreement, including an agreement that automatically terminated as a result of an assignment, at an in-person meeting called for that purpose. But things don’t always go as planned, and a fund board cannot meet in person on short notice, or the fund fails to obtain timely shareholder approval. **Securities and Exchange Commission** rules may provide an escape valve in these situations so that funds can continue to operate seamlessly.

The rules generally provide that when an investment advisory agreement terminates, either by board action or due to a change of control, the board of directors may approve an interim advisory agreement by meeting in-person or by telephone.

Generally, the interim agreement must provide that the fund will pay advisory fees into an escrow account. Only after the board approves a new agreement at an in-person meeting, and shareholders approve that agreement, will the adviser be entitled to the escrowed funds. If the fund fails to obtain the required approvals, the interim adviser would be entitled to receive compensation limited to the cost of providing its advisory services.

Fund directors should ensure that if they rely on this rule, they comply with all the rule’s requirements so as to avoid a foot-fault and an improperly executed agreement.

When dealing with a change of control of an adviser or with a fund reorganization, fund boards face numerous challenges that can become complex and involve passions on all sides. Whatever a fund board concludes, and however it reaches that conclusion, the board should consult with independent outside counsel and create a written record demonstrating that it was fully informed, acted independently and met its fiduciary obligations.