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Skadden

Investment Management Alert

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Leveling the Playing Field for Closed-End Funds: Shareholder Rights Plans as an Alternative to State Control Share Statutes

On December 5, 2023, the U.S. District Court for the Southern District of New York (SDNY) granted summary judgment in favor of a group of plaintiffs led by Saba Capital Management, L.P. in its case challenging a number of Maryland-domiciled closed-end funds' adoption of resolutions opting in to the Maryland Control Share Acquisition Act.[1] The court found that these resolutions violated Section 18(i) of the Investment Company Act of 1940 (1940 Act)[2] and ordered recission of such resolutions. This decision follows on the heels of a decision from the U.S. Court of Appeals for the Second Circuit affirming a separate SDNY ruling that certain Massachusetts-domiciled closed-end funds violated Section 18(i) by adopting provisions in their bylaws mimicking a control share statute.[3]

In light of these SDNY and Second Circuit decisions, closed-end funds may want to consider shareholder rights plans as an alternative to relying on state control share statutes or control share bylaws as a means to level the playing field and force activist managers to engage in substantive negotiations with a closed-end fund's board concerning their takeover proposals or other desired "liquidity" events.

Shareholder Rights Plans

Shareholder rights plans have long been used by operating companies to defend against the threat of hostile activity that is not in stockholders' best interests, and many operating companies keep rights plans "on the shelf" so that they can be adopted quickly by the board of directors should a threat arise. Rights plans are typically adopted either (i) in response to a hostile tender offer, or (ii) to stop a third party from obtaining "creeping" control of a company.

[1] *Saba Capital Master Fund, LTD. et al. v. ClearBridge Energy Midstream Opportunity Fund Inc. et al.*, Case No. 23-cv-5568 (SDNY); Md. Code Ann., Corps. & Ass'ns § 3-702. Control share statutes are portions of state corporate law, typically enacted in response to the corporate raider strategies of the 1980s, that say once an acquiring person reaches a certain threshold of ownership, the acquiring person must go to the unaffiliated shareholder base and get its approval before voting shares in excess of the applicable ownership threshold. This requirement generally kicks in at various increasing levels of ownership, often beginning with 10%, and the unaffiliated shareholder vote typically needed to approve full voting by an acquiring person is 2/3.

[2] Section 18(i) of the 1940 Act provides, "Except … as otherwise required by law, every share of stock … shall be a voting stock and have equal voting rights with every other outstanding voting stock."

[3] *Saba Capital CEF Opportunities 1, Ltd. et al. v. Nuveen Floating Rate Income Fund et al.*, Case No. 22-407 (2d Cir., Nov. 30, 2023).

Once adopted, a shareholder rights plan makes a company a harder target for hostile activity by confronting a would-be acquirer with significant dilution in the event they acquire voting shares of the company without board approval in excess of a threshold amount determined by the board, typically 10-20% of outstanding shares. Upon the rights being triggered, all holders of rights, other than the triggering party, may buy additional shares in the company — or, in certain cases, the stock of the potential acquirer — at a substantial discount to the then-current market price. As a result, parties interested in acquiring a significant ownership position in a company are encouraged to negotiate directly with the board and are discouraged from attempting to seek to achieve a position of substantial influence or control while ignoring the interests of other unaffiliated shareholders. This protects the value of all shareholders' positions and enhances the board's bargaining power, flexibility and time to address third-party acquirers or those who want to use concentrated shareholdings to exert undue influence on the management or operations of the fund.

While shareholder rights plans have historically been adopted by companies "on a clear day" (*i.e.*, not in the face of a present threat), today rights plans are commonly adopted in response to significant stock price volatility, unsolicited acquisition proposals, activist campaigns or third-party accumulations of a significant stake in a company. Courts have been sympathetic to the proposition that rights plans serve as a mechanism to require a bidder to increase its price, either unilaterally or through negotiation with the board of directors, to protect the company against an inadequate offer and to give the board time to formulate an alternative to an unsolicited proposal that is not in the best interests of the company and its shareholders.

In the last few years, the number of unsolicited takeovers and hostile actions impairing shareholder value in closed-end funds has increased exponentially. Just this year we have seen activist closed-end fund investors nominate dissident slates of directors and submit shareholder proposals seeking, among other things, to:

- Terminate advisory agreements.
- Declassify boards.
- Amend bylaws.
- Adopt plurality voting standards in contested elections.
- Eliminate the applicability of control share statutes (other than those that are the subject of the SDNY and Second Circuit decisions).
- Conduct quarterly tender offers and merge with existing open-end funds.

Generally, closed-end fund activism is designed to make significant profits for the activist and its investors at the expense of the fund. We have also increasingly seen full takeovers of closed-end funds. In a full takeover of a closed-end fund:

- The activist succeeds in obtaining a majority of the board seats.
- Typically any remaining directors not affiliated with or nominated by the activist resign.
- The new board terminates the fund's existing adviser and hires a manager affiliated with the activist (or the activist itself).
- The new board and adviser radically change the fund's investment strategy. This benefits the activist by providing a profitable new stream of fee revenue and another vehicle to support further activism.

1940 Act Considerations

Although the 1940 Act restricts the use of rights plans by registered investment companies in certain ways, rights plans can be crafted within such restrictions and remain a viable option when an activist threatens long-term shareholder value in a closed-end fund.

Section 18(d) of the 1940 Act prohibits any registered fund from issuing any warrant or right to subscribe to or purchase securities of the fund, except those expiring not later than 120 days after their issuance which are issued exclusively and ratably to a class or classes of the fund's shareholders. Furthermore, Section 23(b) of the 1940 Act generally prohibits a closed-end fund from selling its common stock at a price below net asset value unless a specified statutory exception applies. One statutory exception, contained in Section 23(b)(4), is upon the exercise of any warrant issued in accordance with the provisions of Section 18(d).

Federal court cases have concluded that (1) a closed-end fund's use of a shareholder rights plan does not violate Section 18(d), 18(i) or 23(b) of the 1940 Act,[4] and (2) a closed-end fund did not violate Section 18(d) of the 1940 Act by serially adopting a shareholder rights plan every 120 days.[5]

Lola Brown I held, "The Rights Agreement unambiguously satisfies § 18(d)'s requirement that rights be issued proportionately to a class or classes of shareholders. One right is attached to each share. When triggered, [the fund's] poison pill allows all shareholders, except the Acquiring Person, to exercise their rights. A voluntary act of a shareholder to acquire holdings above the poison pill trigger does not violate § 18(d)'s requirement that

[4] *Neuberger Berman Real Estate Income Fund Inc. v. Lola Brown Trust No. 1B*, 342 F. Supp. 2d 371 (D. Md. 2004) (*Lola Brown I*).

[5] *Neuberger Berman Real Estate Income Fund Inc. v. Lola Brown Trust No. 1B*, 485 F. Supp. 2d 631 (D. Md. 2007) (*Lola Brown II*).

rights be issued *ratably*."[6] Given the court's holding regarding Section 18(d), it similarly held that there was not a violation of Section 23(b).[7] With respect to Section 18(i), the court held, "The poison pill does not change the fact that all shares are granted equal voting rights. The triggering of the poison pill on the Distribution Date does not revoke voting rights from any shares. Although the triggering of the poison pill will result in a reduction of the Acquiring Person's ownership interest, this is an issue of dilution of economic interest and corresponding voting power and has nothing to do with the voting rights of the shares themselves."[8]

Lola Brown II held that a closed-end fund's serial renewal of a shareholder rights plan did not violate Section 18(d). The court explained that it was "not an impossible reading of" Section 18(d) "to interpret the statutory language as unconcerned with the *number* of poison pills, but rather, as the language suggests, as concerned only with the *duration* of any particular poison pill."[9] The court further explained that this was the most "logical" reading of the statute as well, it being "supported by consideration of the evident purposes of a legitimate poison pill."[10] The particular facts and circumstances involved here — namely, the "legitimate" use of a shareholder rights plan in circumstances where shareholder rights plans have historically been used and approved — appears to be an important factor in the *Lola Brown II* court's analysis.

The SEC staff as a body, and the commission itself, have not publicly expressed a view as to the legality under the 1940 Act of registered investment companies adopting shareholder rights plans. However, in the only public statements made on the topic, the SEC staff acknowledged that, as described above, the only federal court cases to consider the legality of a closed-end fund adopting a shareholder rights plan under the 1940 Act concluded that such adoption, and the serial renewal of the shareholder rights plan every 120 days, did not violate Section 18(d) of the 1940 Act.[11]

The foregoing federal court analyses are, notably, simple and straightforward applications of the plain language of the 1940 Act. The simplicity of this explanation is a beneficial characteristic for closed-end funds, and for the viability of shareholder rights plans as an alternative playing field-leveling option to state control share statutes, in contrast to the more complex and nuanced explanations for why state control share statutes do not violate Section 18(i) of the 1940 Act. Moreover, unlike with state control share statutes (until recently), this analysis has been tested in federal court and is subject to direct holdings, and the Second Circuit favorably distinguished the Section 18(i) holding in *Lola Brown I* in reaching its conclusion regarding control share bylaws.[12] In *Lola Brown I* the plaintiff had argued that an acquiring person under a shareholder rights plan no longer had equal voting rights once the rights plan was triggered because the rights plan prohibits the acquiring person from exercising the rights. *Lola Brown I* characterized this argument as "without merit" and the Second Circuit appears to agree with that assessment.

Conclusion

Closed-end fund boards and their managers should take note of shareholder rights plans as an option to protect the value of all shareholders' positions and enhance the board's bargaining power, flexibility and time to address third-party acquirers or those who want to use concentrated shareholdings to exert undue influence on the management or operations of the fund. The development and maintenance of a rights plan "on the shelf" is relatively inexpensive and can provide a critical tool for a board to consider if an activist threatens long-term shareholder value.

[6] *Lola Brown I* at 375 (emphasis in original).

[7] *Id.* at 376.

[8] *Id.*

[9] *Lola Brown II* at 638 (emphasis in original).

[10] *Lola Brown II* at 638.

[11] SEC Staff Statement on Control Share Acquisition Statutes (May 27, 2020), at nn.13 & 18; Boulder Total Return Fund, Inc., SEC Staff No-Action Letter (Nov. 15, 2010), at n.5.

[12] *Saba Capital CEF Opportunities 1, supra*, slip op. at 31-32.

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