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Court Upholds Legality of Poison Pills for Closed-End Funds but Limits Successive Plans

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On March 28, 2025, the U.S. District Court for the Southern District of New York (SDNY) held that it was legal under the Investment Company Act of 1940 (1940 Act) for a closed-end fund to use a shareholder rights plan (colloquially known as a "poison pill") to fend off a hedge fund seeking to take control of the fund. However, the court disapproved of the use of successive plans if substantively the same, for the same purpose and adopted while a prior plan was still in effect.

The case, initiated by hedge fund Saba Capital Master Fund, Ltd. (Saba) in January 2024, challenged the adoption of a series of poison pills under Sections 18(d) and 23(b) of the 1940 Act. Skadden represented the target of Saba's suit, ASA Gold and Precious Metals Ltd. (ASA), in the implementation of the rights plan and briefing its legality under the 1940 Act. [1]

The decision represents a significant development in the ongoing legal battle between closed-end funds and hedge funds, and validates the use of an important defense that can be employed by closed-end funds targeted by activists.

The court was clear that a shareholder rights plan, in and of itself, does not violate the 1940 Act, and endorsed the long-accepted principle that shareholder rights plans serve a "legitimate role" of providing a board with "an opportunity to consider alternatives" when faced with a hostile tender offer, creeping control or similar threat.

Closed-End Fund Activism

The court's decision is the latest in a series of cases brought by Saba challenging various mechanisms adopted by closed-end funds to defend against short-term arbitrage strategies like Saba's. For example, Saba has successfully challenged closed-end funds' adoption of control share provisions — which restrict a shareholder's ability to vote shares above a certain percentage threshold without the permission of a majority of the fund's other shareholders — as violative of the 1940 Act.

On the other hand, a Massachusetts Superior Court has blessed certain closed-end funds' adoption of a bylaw amendment that raised the voting standard in contested trustee elections. Specifically, the court found that the so-called "Majority Rule Amendment," which requires a majority of outstanding shares to elect new trustees, was a legitimate defense against short-term arbitragers whose actions often conflict with the investment objectives of the fund and the interests of long-term shareholders. [2]

In recent years, arbitragers like Saba have sought to exploit a unique feature of closed-end funds. Unlike open-end mutual funds, closed-end funds trade on exchanges in the secondary market, and their price often deviates from the fund's net asset value (NAV).

Saba pursues an arbitrage strategy, investing in closed-end funds that trade at a significant discount to NAV. Typically, the arbitrager makes a significant — though still minority — investment in a fund and uses its concentrated voting power to force liquidity events (e.g., tender offers, liquidation of the fund or converting to an open-end fund) that allow it to sell its shares at or near NAV and net a profit.

Arbitragers have also been known to leverage their concentrated voting power to elect their hand-picked directors to a majority of board seats. The new board then forces the fund's existing manager to resign, or simply terminates that position and hires the arbitrager or one of its affiliates to manage the fund, which radically changes the fund's investment strategy. This benefits the arbitrager by providing a profitable new stream of fee revenue and another vehicle to support its arbitrage strategy.

These tactics — liquidity events and fund takeovers — can be detrimental to the funds and their long-term shareholders. Closed-end funds, especially fixed-income closed-end funds, typically have a high number of retail shareholders, including retirees, who invest in such funds over the long term for the high and steady income stream that such funds are particularly well suited to generate.

Shareholder Rights Plans in Closed-End Funds: 1940 Act Considerations

Operating companies have long used shareholder rights plans to defend against the threat of hostile control-seeking activity that is not in shareholders' best interests. 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.

Shareholder rights plans generally operate to make the company a less attractive target to a control-seeking entity. While there are several types, under the quintessential structure, a shareholder rights plan grants each outstanding share the right to purchase a certain number of

newly issued shares at a discounted price. The right to purchase additional shares can be exercised at a later date in particular circumstances.

A rights plan is "triggered" when an entity accumulates a specified percentage of the company's shares. At that point, all shareholders, except the control-seeking entity that triggered the plan, may exercise the right to purchase additional shares. The purchase of additional shares by other shareholders results in the control-seeking entity's shares becoming economically diluted.

Rights plans therefore have the effect of ensuring that, to avoid the risk of economic dilution, a control-seeking entity will not accumulate enough shares to trigger the plan. That, in turn, incentivizes the control-seeking entity to engage with the board, enhancing the board's bargaining power, flexibility and time to address control-seeking entities.

Rights plans are common in operating companies but unusual in the closed-end fund space. This is likely because the 1940 Act restricts the use of rights plans by registered investment companies in some ways:

- Section 18(d) prohibits any registered fund from issuing any warrant or right to subscribe to or purchase securities of the fund, except those expiring no later than 120 days after their issuance (which are issued exclusively and ratably to a class or classes of the fund's shareholders).
- Section 23(b) generally prohibits a closed-end fund from selling its common stock at a price below NAV 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).

Saba's Challenge

In 2023, Saba took steps that appeared to be the initiation of its strategy against ASA, amassing 16.87% of ASA's outstanding shares and nominating a slate of candidates to the board — including Saba employees.

The board, determining that it was in the best interests of ASA and its entire shareholder base, adopted a limited-duration shareholder rights plan on December 31, 2023. That plan expired 120 days after its adoption, but while it was pending, a board committee adopted a substantially similar successive plan. The committee subsequently adopted additional substantially similar plans, each while the preceding plan was still in effect.

In January 2024, Saba sued ASA and the then-board, alleging that the rights plan violated Sections 18(d) and 23(b) of the 1940 Act.

The Court Upholds Closed-End Funds' Use of Shareholder Rights Plan

On March 28, 2025, the court held that because the rights plans "issued a Plan Right, per share, to Saba just as it issued them to other shareholders," it did not violate Section 18(d)'s requirement that rights and warrants be "issued exclusively and ratably to a class or classes of the fund's shareholders." The court reasoned that "Section 18(d) requires only that rights be issued proportionally, and in the context of this case, required only that Plan Rights be allocated on a pro rata basis to all shareholders."

In approving the use of shareholder rights plans, the court also distinguished control share provisions because rights plans "affect[ ] a shareholder's 'economic interests by differentiating their ability to purchase discounted shares' as opposed to … 'impair[ing] their ability to vote the shares they owned.'" Thus, the court held that "so long as the impairment does not apply to the issuance, but rather the subsequent exercise," of a right, it does not compel a finding of a violation of Section 18(d)'s "ratably" requirement.

The court's decision is consistent with Neuberger I, a 2004 decision in the U.S. District Court for the District of Maryland that similarly rejected the argument that the rights plan in that case violated Section 18(d). The court held that the plan at issue, which functioned similarly to the one adopted by ASA, "unambiguously satisfie[d] § 18(d)'s requirement that rights be issued proportionately to a class or classes of shareholders." The court reasoned that, pursuant to the plan, "[o]ne right is attached to each share," which is all that Section 18(d) requires.

The court noted that "[a] voluntary act of a shareholder to acquire holdings above the … trigger does not violate § 18(d)'s requirement that rights be issued ratably." Because the rights were issued ratably pursuant to Section 18(d), the court also held that they did not violate Section 23(b).

The Court Rules That Closed-End Funds Cannot Adopt Multiple Successive, Identical Rights Plans Prior to the Expiration of the Preceding Rights Plan

The court held that "a single rights plan, in continuous operation through materially identical extensions, violates the 120-day expiration requirement" of Section 18(d). The court reasoned that "permit[ing] a closed-end investment company to remain in a rights plans state ad infinitum" would render the expiration requirement meaningless. That said, the court did not "reach the question of whether successive rights plans, adopted after the prior one expired, violates the 120-day requirement."

This portion of the court's decision diverges from Neuberger II, a 2007 follow-on case to Neuberger I, where the court upheld the same fund's serial renewal of the rights plan. The court noted the most "logical" reading of Section 18(d) is that it is "unconcerned with the number of poison pills, but rather, as the language suggests, as concerned only with the duration of any particular poison pill." Because each rights plan expired within Section 18(d)'s 120-day limit, there was no violation.

SDNY noted that Neuberger II "analyzed the utility of poison pills in the context of a hostile tender offer, and expressly noted the 'legitimate role of the poison pill' expires after the board has had an opportunity to consider alternatives," which the court found had occurred here.

SDNY further distinguished Neuberger II on the grounds that, unlike the Neuberger II rights plans, it concluded the ASA rights plans were (1) "not distinct in form or substance," (2) "adopted during the pendency of the prior plan, such that it never actually expired," and (3) in the Court's view, adopted for the "same purpose."

Final Thoughts

The court's ruling validates an important defensive mechanism for closed-end fund boards to enhance the board's bargaining power, flexibility and time to address arbitrage activity of activist hedge funds or other would-be acquirers. Boards may consider proactively developing a shareholder rights plan to keep "on the shelf" in the event they become the target of an activist threat.

Boards developing shareholder rights plans should, however, keep in mind the court's ruling on the 120-day rule disapproving of identical, successive plans adopted ad infinitum and may consider changing the terms of the plan before adopting a successive plan, waiting a short period between adoption of successive plans or otherwise taking steps to shape successive plans around the court's ruling.

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[1] Saba Capital CEF Opportunities I, Ltd. v. Nuveen Floating Rate Income Fund, 88 F.4th 103 (2d Cir. 2023).(go back)

[2] Eaton Vance Senior Income Trust v. Saba Capital Master Fund, Ltd., 2024 WL 4579652 (Super. Ct. Mass. Oct. 21, 2024).(go back)