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Shareholder Activism Update

Recent Court Rulings Shape Strategies for Closed-End Funds in Shareholder Activism Context

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Recent decisions from the U.S. Court of Appeals for the Second Circuit (Second Circuit) and the U.S. District Court for the Southern District of New York (SDNY) have brought attention to anti-takeover strategies employed by registered closed-end investment companies amidst shareholder activism campaigns. These rulings highlight the scrutiny placed on the legality and effectiveness of certain defensive tactics. In *Saba Capital CEF Opportunities 1, Ltd. et al. v. Nuveen Floating Rate Income Fund et al.* (November 30, 2023)[1], the Second Circuit invalidated and revoked an amendment to Nuveen's bylaws. This amendment aimed to limit shareholder voting rights for shares acquired beyond specified ownership thresholds. Subsequently, in *Saba Capital Master Fund, Ltd. et al. v. ClearBridge Energy Midstream Opportunity Fund Inc. et al.* (December 5, 2023)[2], the SDNY granted summary judgment in favor of plaintiffs led by the same shareholder seeking rescission of resolutions adopted by numerous closed-end funds attempting to opt-in to the Maryland Control Share Acquisition Act (MCSAA), which curtails voting rights for shares acquired above certain ownership levels without shareholder consent for their restoration. These cases emphasize that any attempt to alter the foundational principle of "one share, one vote" under Section 18(i) of the Investment Company Act of 1940 (Company Act) is impermissible. Consequently, investment companies are urged to explore alternative defensive measures in response to potential hostile shareholder actions.

Saba Capital CEF Opportunities 1, Ltd. v. Nuveen Floating Rate Income Fund

In *Nuveen*, the registered closed-end investment company adopted a bylaw amendment that limited the ability of shareholders with holdings greater than 10% in any particular fund to vote any additional shares purchased. In affirming the SDNY's summary judgment ruling that the amendment violated Section 18(i) of the Company Act, the Second Circuit rejected the argument commonly used by investment companies in an attempt to justify their use of similar tactics – that they do not affect the voting rights of shares, but instead, only affect the voting rights of shareholders. In particular, the court found that the state law distinction did not assist in interpreting federal statutes, and the voting conditions and exceptions on

[1] *Saba Capital CEF Opportunities 1, Ltd. v. Nuveen Floating Rate Income Fund*, Case No. 22-407 (2nd Cir., Nov. 30, 2023).
[2] *Saba Capital Master Fund, Ltd. v. ClearBridge Energy Midstream Opportunity Fund Inc.*, Case No. 23-cv-5568 (SDNY).

presumptively unlawful acquisitions in another section of the Company Act and the alleged congressional intent to prevent activist investors did not overcome the plain language of Section 18(i).[3]

In rejecting Nuveen's share-shareholder distinction argument, the Second Circuit discussed a Maryland district court's decision[4] holding that an investment fund's shareholder rights plan (aka "poison pill") is valid under the Company Act. The Second Circuit emphasized that the key distinction between a poison pill and the bylaw amendment at issue is that the former affected investors' economic interests by differentiating their ability to purchase discounted shares whereas the latter impaired investors' ability to vote their shares.

Note that Section 18(i) allows for exceptions "otherwise required by law." Certain state statutes provide for control share provisions such as Maryland's statutory control share provisions.[5] Despite the applicability of Maryland control share provisions to business development companies (unless they opt out), the decisions discussed above have cast doubt on their effectiveness for registered closed-end funds when they opt-in to such provisions.

In light of these legal developments, closed-end funds should carefully consider alternative defensive strategies such as poison pills, which have received favorable court endorsements.[6] The adoption of a poison pill can dissuade activism campaigns, provide boards with valuable time to negotiate or explore alternative options, and protect the interests of all shareholders and safeguard the long-term value of the fund. Closed-end funds may also want to consider preparing a "shelf" poison pill that is not immediately implemented, but that can be quickly adopted on short notice in response to an activism campaign.

[3] Section 18(i) of the Company Act requires, except as "as otherwise required by law," that each share of stock issued by a registered closed-end fund "shall be a voting stock and have equal voting rights with every other outstanding voting stock."
[4] *Neuberger Berman Real Estate Income Fund, Inc. v. Lola Brown Trust No. 1B*, 342 F. Supp. 2d 371 (D. Md. 2004) ("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.")
[5] Md. Code Ann., Corps. & Ass'ns § 3-702.
[6] Any closed-end investment company considering use of a poison pill should consider the applicable requirements and restrictions under the Company Act such as Section 23(b) (offers below net asset value) and Section 18(d) (rights to purchase shares).

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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