The Asset Management Industry
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INVESTMENT COMPANY INSTITUTE

MEMO# 35576

January 10, 2024

SDNY Declares Control Share Resolutions of Maryland Closed-End Funds to Violate the 1940 Act; Summary Judgement Granted for Activist Shareholder

[35576]

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TO: ICI Members
Investment Company Directors
Closed-End Investment Company Committee SUBJECTS: Closed-End Funds RE: SDNY Declares Control Share Resolutions of Maryland Closed-End Funds to Violate the 1940 Act; Summary Judgement Granted for Activist Shareholder

On December 5, 2023, Judge Rakoff of the United States District Court for the Southern District of New York (SDNY) issued an Order granting summary judgement to Saba Capital Management, L.P. ("Saba"), declaring that the control share resolutions adopted by the defendant closed-end funds and trustees violated Section 18(i) of the Investment Company Act of 1940 ("1940 Act") and ordering that these resolutions be rescinded.[1] On January 4, 2024, Judge Rakoff issued an Opinion explaining the reasons for the rulings in the Order.[2] As of the date of this memo, every closed-end fund defendant in this case has appealed the SDNY decision.

Background

A control share statute is a state law that generally restricts the rights of a shareholder who owns more than a certain percentage of a company's shares from voting those shares in excess of the set threshold (i.e., "control shares"), unless the other non-interested shareholders restore those rights. Control share statutes function as anti-takeover devices. Since the SEC staff withdrew its guidance prohibiting closed-end funds from using control share provisions,[3] closed-end funds have turned to control share statutes and adopted control share resolutions in their governing documents to protect long-term investors from activists.[4]

Saba has been successful in other litigation regarding control share provisions for closed-

end funds organized as Massachusetts business trusts.[5] With its Complaint, Saba sought to have the SDNY apply prior Second Circuit precedent related to closed-end funds organized as Massachusetts business trusts to closed-end funds organized in Maryland.[6]

Procedural History

On June 29, 2023, Saba filed its Complaint in the SDNY against sixteen closed-end funds and several of their trustees.[7] Each closed-end fund had either opted into the Maryland Control Share Acquisition Act ("MCSAA")[8] or had bylaws that had the effect of a control share resolution. Saba contended that by opting into the MCSAA or adopting comparable bylaws, the closed-end funds were violating Section 18(i), which states that "[e]xcept as . . . otherwise required by law, every share of stock hereafter issued by a registered management company . . . shall be a voting stock and have equal voting rights with every other outstanding voting stock[.]" Saba argued that because the control share resolutions of the closed-end funds do not satisfy the language of Section 18(i) that all common shares "shall be a voting stock and have equal voting rights with every other outstanding voting stock[,]" such control share resolutions should be rescinded.

On September 26, 2023, Judge Rakoff issued an opinion and order dismissing five of the closed-end funds and their trustees named in the Complaint.[9] The five dismissed closed-end funds had in their bylaws forum selection clauses requiring actions arising pursuant to federal law, including under the 1940 Act, to be brought in Maryland.[10] Thus, the five closed-end funds with bylaws covering actions arising from federal law were dismissed while Saba's claims against the remaining closed-end funds were allowed to continue.[11]

Summary Judgement – Ordering Rescission of the Control Share Resolutions

On the merits of the Complaint, the court granted summary judgment for Saba, stating that the Second Circuit's decision in Saba Capital CEF Opportunities 1, Ltd. v. Nuveen Floating Rate Income Fund, 88 F.4th 103 (2d Cir. 2023) compelled such result. According to the SDNY, the 1940 Act not only required all common stock to be "voting stock," but specifically regulated the stock's function – i.e., that the stock "presently entitle" the owner to vote the stock – and that the stock have equal voting rights with all other fund voting stock. The control share resolutions, which stripped voting rights for shares owned beyond a certain threshold by any person, violated the 1940 Act by 1) making the stock lose its function, i.e., no longer "presently entitling" the stock to vote, and thus no longer constituting "voting stock;" and 2) being inapposite to Section 18(i)'s guarantee of equal voting rights.

The SDNY also addressed the "otherwise required by law" clause found in Section 18(i). The court noted that the Second Circuit in Nuveen did not specifically consider whether control share resolutions adopted pursuant to state statute, and therefore permissible under state law, are "otherwise required by law" and thus safe from Section 18(i)'s requirements. The court held that the fact that Maryland law allows funds to adopt control share resolutions does not in any way mean that Maryland law requires control share resolutions.[12] Therefore, the court determined that control share resolutions adopted pursuant to the MCSAA were not "otherwise required by law" nor allowable under the 1940 Act.

Additional Procedural Holdings

- Standing: Saba had standing to sue, even though it did not own more than 10% of every named closed-end fund. Because Saba stated that it would have acquired more shares but for the control share provisions and the imminent risk they posed to Saba's

voting rights, the court found this to be "sufficiently imminent and substantial, and [such] harm is concrete" to constitute standing.[13]

- Personal Jurisdiction: Because the 1940 Act is a federal statute that authorizes nationwide service of process, the relevant contacts for determining a court's personal jurisdiction is whether a fund has contacts with the United States as a whole. Thus, because the closed-end funds are organized under Maryland law, they have inherently sufficient contacts for the SDNY to exercise jurisdiction.[14]
- Venue: In distinguishing the Complaint from Gilson v. Pittsburgh Forgings Co., 284 F. Supp. 569 (S.D.N.Y. 1968),[15] the court held that closed-end funds "transact business" in New York, and thus the venue requirements under the 1940 Act are satisfied, when a closed-end fund lists on the NYSE and uses New York brokers and other entities to carry out the fund's investment transactions.
- Trustees' Motion to Dismiss: The court denied the trustees' motion to dismiss the claims against them and allowed litigation to proceed with both the funds and trustees as joint defendants. The court reasoned that the trustees at issue were trustees of the closed-end funds when the funds adopted the control share resolutions and therefore participated in their adoption. The court held that the Complaint stated a claim against the funds and the trustees alike for the same conduct and the relief sought covered both the funds and trustees.
- Discovery: Several closed-end funds argued that discovery was needed so that they could demonstrate that rescission of the control share resolutions was not mandatory in this case. Rescission of a resolution offending the 1940 Act is mandatory unless two conditions are met (1) leaving the offending resolutions in place would produce a more equitable result than rescission; and (2) denying rescission would not be inconsistent with the 1940 Act. The court determined that because the 1940 Act unambiguously allows a court to grant rescission even if those showings have been met, and because the court did not believe any showing by the closed-end funds would change its order for rescission, the court denied discovery.

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Notes

[1] Order, Saba Capital Master Fund, Ltd., et al. v. BlackRock Municipal Income Fund, Inc., et al., No. 23-cv-5568 (JSR) (S.D.N.Y. Dec. 5, 2023), available at https://storage.courtlistener.com/recap/gov.uscourts.nysd.601294/gov.uscourts.nysd.601294.118.0.pdf.

[2] Opinion, Saba Capital Master Fund v. BlackRock Municipal Income Fund, No. 23-cv-5568 (JSR) (S.D.N.Y. Jan. 4, 2024), available at https://storage.courtlistener.com/recap/gov.uscourts.nysd.601294/gov.uscourts.nysd.601294.124.0.pdf.

[3] See SEC Division of Investment Management, Control Share Acquisition Statues (May 27, 2020), available at https://www.sec.gov/investment/control-share-acquisition-statutes. For a summary of the staff's withdrawal letter, see ICI Memorandum No. 32487, available at https://www.ici.org/memo32487.

[4] Activists often acquire substantial share positions in closed-end funds to force "liquidity" events, such as a liquidation of the fund, a conversion to a mutual fund, or a tender offer. These forced "liquidity" events may hurt long-term shareholders who invested in a closed-end fund for its dividend yield, as the closed-end fund will cease to exist (in the event of a liquidation), be substantially changed (in the event of a conversion to a mutual fund), or be significantly reduced in scale and result in higher per share expenses (in the event of a tender offer).

[5] E.g., Saba Capital CEF Opportunities 1, Ltd. v. Nuveen Floating Rate Income Fund, 88 F.4th 103 (2d Cir. 2023). For a summary of the Nuveen opinion, see ICI Memorandum No. 35522, available at https://www.ici.org/memo35522.

[6] Because Massachusetts did not have a codified control share statute for closed-end funds organized as Massachusetts business trusts, the courts in the prior Saba cases did not analyze the question of whether a closed-end fund may rely on a codified control share statute, like that found in Maryland, and enact control share resolutions without violating the 1940 Act.

[7] Complaint, Saba Capital Master Fund, Ltd., et al. v. Clearbridge Energy Midstream Opportunity Fund, Inc., et al., No. 23-cv-5568 (JSR) (S.D.N.Y. June 29, 2023).

[8] Md. Code Ann., Corps. & Ass'ns §§ 3-701 et seq.

[9] Opinion and Order, Saba Capital Master Fund v. Clearbridge Energy Midstream Opportunity Fund, No. 23-cv-5568 (JSR) (S.D.N.Y. Sept. 26, 2023), available at https://storage.courtlistener.com/recap/gov.uscourts.nysd.601294/gov.uscourts.nysd.601294.79.0.pdf.

[10] Four of the dismissed closed-end funds specifically mentioned federal law and the 1940 Act in their bylaw forum selection clauses. One closed-end fund's bylaw forum selection clause used broad language covering claims "based on any matter arising out of, or in connection with" the fund, which was found by the court to cover Saba's claims.

[11] Subsequently, three of the dismissed closed-end funds entered into a standstill agreement with Saba.

[12] Under the MCSAA, Maryland's control share statute does not apply to closed-end funds organized as corporations unless a closed-end fund's board of directors adopts a resolution to be subject to the MCSAA. Md. Code Ann., Corps. & Ass'ns § 3-702(c)(4). Whether a control share statute that automatically applies, such as Delaware's, would render a different holding was not addressed by the court.

Delaware amended its Delaware Statutory Trust Act, effective August 1, 2022, to adopt a control share acquisition statute that automatically subjects all listed closed-end funds registered under the 1940 Act and business development companies organized as Delaware statutory trusts to it. The Delaware control share statute is forward-looking only and allows the fund's board of trustees to exempt specific acquisitions or classes of acquisitions from the control share statute. For more information on the Delaware Statutory Trust Act amendments, see ICI Memorandum No. 34242, available at https://www.ici.org/memo34242.

Maryland also recently amended its Maryland Statutory Trust Act, effective October 1, 2023, to automatically apply its control share statute to a Maryland statutory trust that is (i)

a closed-end investment company as defined under the 1940 Act and (ii) formed on or after October 1, 2023. Closed-end funds subject to the automatic application of the Maryland Statutory Trust Act control share statute were not at issue in the Saba litigation. For more information regarding the Maryland Statutory Trust Act amendments, see ICI Memorandum No. 35319, available at https://www.ici.org/memo35319.

[13] Notably, the court rejected Saba's other standing claim that it had suffered an actual and concrete injury merely because it was a party to an illegal contract due to being subject to the closed-end funds' control share provisions. In particular, the court concluded that Saba did not articulate how being party to an illegal contract imposes on its own a concrete harm.

[14] Further, in a footnote, the court noted that it could also exercise personal jurisdiction over the closed-end funds pursuant to New York's long-arm statute that allows claims against a defendant who transacts any business within the state. See N.Y. C.P.L.R. § 302(a).

[15] Gilson held that merely listing on the NYSE did not itself satisfy the "transact business" requirement for venue under the federal securities laws. The court stated that while the "principle from Gilson . . . may arguably have some force when a defendant is an operating company that has some 'ordinary business[,]'" closed-end funds have no "ordinary business" other than to invest the capital provided to them by investors. Listing on the NYSE and using New York entities to carry out investment decisions was determinative of venue for investment companies.
