

**FEDERAL DISTRICT COURT OF MARYLAND HOLDS THAT  
SERIAL POISON PILLS AND VOTING RIGHTS LIMITATIONS ON  
CONTROL SHAREHOLDERS DO NOT VIOLATE THE INVESTMENT COMPANY  
ACT OF 1940 WHEN ADOPTED BY A CLOSED-END FUND AS DEFENSIVE  
TACTICS AGAINST A HOSTILE TENDER OFFER**

### Recent District Court Decision

Closed-end investment funds have been subject to various actions by shareholder activists related to the discount from net asset value at which fund shares often trade. In 2004, the Federal District Court of Maryland upheld the use of a Shareholder Rights Agreement (“SRA”) -- more commonly referred to as a “poison pill” -- by a closed-end fund in order to defeat a hostile takeover attempt.<sup>1</sup> The party initiating the hostile takeover (the “dissident”) sought to acquire a majority of the outstanding shares of the fund in order to oust the current Board of Directors, replace the adviser and the administrator of the fund with affiliates of the dissident and change the investment strategy of the fund.

Recently, the same court ruled that the use of serial poison pills that remained in effect continually over a period of over 2 ½ years did not violate § 18(d) of the Investment Company Act of 1940, as amended (the “1940 Act”), where the provisions of the successive SRAs varied in a meaningful way and no individual SRA had a term greater than 120 days.<sup>2</sup>

The court also implicitly rejected an argument that the voting rights limitations on control shareholders in the Maryland Control Share Acquisition Act (the “MCSAA”)<sup>3</sup> violated § 18(i) of the 1940 Act by divesting control shareholders of their right to vote their shares equally with all other shares. In addition, the court interpreted the relevant voting provisions of the MCSAA so that a control shareholder’s voting rights were capped at the number of shares held on the date the fund opted in to the MCSAA even though that occurred after the shareholder had already become a “control shareholder” under the MCSAA.

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<sup>1</sup> *Neuberger Berman Real Estate Income Fund v. Lola Brown Trust No. 1B*, 342 F. Supp. 2d 371 (D. Md. 2004). The court held that the poison pill was not inconsistent with §§ 18(d), 18(i) or 23(b) of the Investment Company Act of 1940, discussed later in this memorandum. The decision dealt only with the use of the SRA in the first instance, and did not address the use of serial SRAs, nor did the court render any decision concerning the Maryland Control Share Acquisition Act. However, the 2004 decision discussed these issues and ultimately this discussion was adopted as the holding of the court in the 2007 decision that is the focus of this memorandum. See *infra* note 2 and accompanying text.

<sup>2</sup> *Neuberger Berman Real Estate Income Fund v. Lola Brown Trust No. 1B*, No. AMD 04-3056, 2007 U.S. Dist. LEXIS 34054 (D. Md. May 8, 2007).

<sup>3</sup> MD. CODE ANN., CORPS. & ASS’NS §§ 3-701 et seq. (LexisNexis 2007).

As a result of the decision, closed-end funds organized in Maryland have two additional defensive measures when confronted with shareholder-initiated actions that fund Boards consider contrary to shareholder interests.

### **Serial Poison Pills**

A typical poison pill grants a right to all existing shareholders, other than the person or group whose actions trigger the pill, to purchase a specified number of newly issued securities in the company at a significantly discounted price upon the occurrence of certain triggering events, such as the purchase by any one shareholder or a related group of shareholders of a specified percentage of the company's outstanding shares. The exercise of these rights would severely dilute the interest of such person or group and therefore may deter a potential dissident from initiating a hostile tender offer.

Section 23(b) of the 1940 Act generally prohibits a closed-end fund from issuing shares at a price below net asset value. Since a poison pill, if triggered, would require a fund to issue stock below net asset value, poison pills could be construed to be prohibited under § 23(b). However, § 18(d) provides an exception to this limitation by exempting from § 23(b)'s prohibition securities issued pursuant to rights having a maturity of 120 days or less. In the instant case, the fund adopted a new SRA every 120 days, such that a poison pill was in effect for the entire period that the dissident's hostile tender offer seeking a controlling interest in the fund remained open. The issuance of these serial poison pills was challenged by the dissident as contrary to the policy underlying § 18(d). The court disagreed, reasoning that the plain language of § 18(d) supports the "most natural [and] logical" conclusion that the statute is concerned only with the duration of any single rights issue, not with the several successive rights issues made by a fund. The court noted that if Congress had intended the statute to preclude multiple successive rights issues, the language of the statute should have addressed both their duration and number, and not simply duration alone.

The court's analysis stressed that each of the multiple successive SRAs adopted by the fund, "though similar [to the other SRAs, was] a distinct and separate offering, both in form and substance." Under the first SRA, all shareholders of the fund's common stock, with the exception of the shareholder triggering the SRA, were given the right to purchase three additional shares of fund common stock for each outstanding share they owned, at a price of \$0.0001/share (the stock's par value), once the SRA had been triggered by the purchase of 11% or more of the fund's outstanding shares by any shareholder. In successive SRAs, multiple changes were made. Most notably, adjustments were made to the number of shares each right entitled an owner of common stock (other than the triggering shareholder) to purchase at the discounted price and the percentage of outstanding shares required to be purchased by a shareholder to trigger the SRA. Other terms were also added and removed from one SRA to the

next, such as non-quantitative triggering events (*i.e.*, the filing of a Schedule 13D or 13G by a shareholder).<sup>4</sup>

### **Voting Rights Limits on “Control Shares” under the MCSAA**

Section 3-701(d) of the MCSAA defines “control shares” in part as the excess over 10% of all outstanding voting shares of an issuer,<sup>5</sup> and § 3-702(a)(1) divests the holder of these control shares of the right to vote them. Section 3-702(c)(4) provides that the MCSAA’s limitations will not apply to any shareholder that “has become a holder of control shares” before the issuer has opted in to the relevant provisions of the MCSAA.

At the time the hostile tender offer was initiated, the dissident owned slightly more than 10% of all outstanding voting shares of the fund. The fund diluted the dissident’s holdings to below the 10% threshold by issuing shares to an affiliate at net asset value in a private placement. The fund then opted in to the MCSAA, taking the position that the dissident was precluded from voting any shares in excess of 10% that it would acquire in the future. The dissident claimed that the MCSAA was inapplicable on the basis that (1) the dissident had become a control shareholder before the fund opted in to the MCSAA and was thus exempt from the MCSAA’s voting limitations on shares purchased after the fund opted in, and (2) the MCSAA conflicted with § 18(i) of the 1940 Act, which generally requires that every share of stock issued by a closed-end fund shall be a voting stock with voting rights equal to those of every other share of outstanding voting stock.

Without explicitly addressing the issue of whether the MCSAA provisions conflicted with § 18(i) and whether, if so, § 18(i) pre-empted the MCSAA in that respect, the court determined that the dissident could vote the number of shares held on the date the fund had opted in to the MCSAA and that the attempt to dilute the dissident’s interest was ineffective. More importantly, however, the court held that the dissident was not exempt from the MCSAA’s limitations even though it had become a “control shareholder” before the fund opted in to the voting limitations of the MCSAA. Instead, the court held that the dissident’s voting rights were capped at the number of shares held on the date the fund opted in to the MCSAA, and shares acquired after the opt in could not be voted. The court reasoned that this result was consistent with the policy underlying the MCSAA, which was to give a fund’s Board of Directors time to opt in to the MCSAA after learning of a 10% shareholder, in order to be able to protect minority shareholders from coercive, hostile takeover attempts.

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<sup>4</sup> In a footnote, the court also interpreted the failure of the Securities and Exchange Commission (the “SEC”) to take a public position in the dispute -- despite “vigorous lobbying” to the SEC by both parties and a direct request by the court -- as acquiescence that the serial poison pills did not contravene the 1940 Act. However, given the SEC’s customary practice of not intervening in litigation below the appellate level, one should not read too much into the SEC’s inaction.

<sup>5</sup> The statute defines two other classifications of “control shares,” which were not relevant in this case.

## Conclusion

This case expands the defensive tactics available to a closed-end fund when faced with shareholder-initiated actions seeking to effectuate a change in control of the fund or, as in the instant case, to take other actions that the Board concludes are not in the best interests of shareholders. Obviously, a careful analysis of the pros and cons of these tactics must be undertaken before any decision is made to implement either or both, given that they could be viewed as management-entrenchment devices. Nonetheless, assuming the case remains good law, closed-end funds can now avail themselves of poison pills in appropriate circumstances in a manner similar to other issuers. In addition, the MCSAA's voting rights limit could prove useful to CEFs incorporated in Maryland as a legitimate means of forcing a hostile shareholder to gain widespread support from the other shareholders before taking any actions that the Board determines to be detrimental to the fund or its shareholders generally.

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