



An Implied Private Right of Action Under the Investment Company Act

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In an August 5 holding that could open the door to a new breed of litigation claims involving mutual funds, the United States Court of Appeals for the Second Circuit ruled that the Investment Company Act of 1940 (“ICA”) creates an implied private right of action that several other courts had previously declined to recognize. Section 47(b) of the ICA provides that “[a] contract that is made, or whose performance involves, a violation of [the ICA] . . . is unenforceable by either party.” The Second Circuit concluded in *Oxford University Bank v. Lansuppe Feeder, Inc.* that Congress’ intent in enacting Section 47(b) was to grant contracting parties a right to sue for rescission of a contract that allegedly violates the ICA. In recent years, most courts have interpreted the ICA as providing only one private right of action—a claim for excessive advisory fees against investment advisers and their affiliates expressly granted to mutual fund shareholders under Section 36(b). While an additional private right of action under the ICA raises the prospect of expanded litigation risk for advisers and funds, the scope of new litigation might be limited in practice by the requirement that the plaintiff be a *party* to the allegedly violative contract.

The dispute in *Oxford University Bank* did not involve a mutual fund. Instead, the litigation initiated in the U.S. District Court for the Southern District of New York was between senior and junior noteholders in a special purpose investment vehicle organized as a trust. The trust claimed exemption from registration as an investment company under the ICA pursuant to Section 3(c)(7)—which exempts issuers whose securities are owned exclusively by “qualified purchasers” as that term is defined in the statute. A junior noteholder, who stood to receive no distribution of the trust’s assets under the trust indenture’s “waterfall” payment provisions, sought to avoid the effect of those provisions and thereby reorder the distribution priority. To this end, the holder asserted a rescission claim under Section 47(b), alleging that certain of the trust’s notes had been resold to non-qualified purchasers, leading the trust to be in violation of the ICA’s registration requirements. A senior noteholder naturally disagreed, and was granted summary judgment enforcing the indenture’s payment provisions, based in part on the district court’s conclusion that no private right of action exists to assert rescission claims under Section 47(b).

On appeal, the Second Circuit disagreed with the trial court that Section 47(b) creates no private right of action. Applying the principles from the U.S. Supreme Court’s seminal decision on private rights of action, *Alexander v. Sandoval* (2001), the panel focused primarily on the text and structure of Section 47(b), which was added to the ICA by a 1980 amendment. Even though

Section 47(b) does not provide an express right to sue as is found in Section 36(b) of the ICA, the court nevertheless found Congress' implied intent to be unambiguous. In particular, the court noted that Section 47(b)(2) provides that "a court may not deny rescission *at the instance of any party* unless such court finds that under the circumstances the denial of rescission would produce a more equitable result than its grant and would not be inconsistent with the purposes of [the ICA]." The court reasoned that this language "necessarily presupposes that a party may seek rescission in court by filing suit" and "is thus effectively equivalent to providing an express cause of action." The panel further concluded that the legislative history of the 1980s amendment supported this interpretation.

The Second Circuit acknowledged that "the Third Circuit and several lower courts have reached the opposite result." The panel reviewed in particular the Third Circuit's contrary reasoning in *Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co.* (2012) and found it unpersuasive—creating a circuit split that raises the prospect of a certiorari petition to the Supreme Court.

What is the practical import of a new private rescission right under ICA Section 47(b) in the courts of the Second Circuit? Any additional private right of action under the ICA certainly raises the prospect of expanded litigation risk for advisers and funds. However, there is an important distinction between this right to sue for rescission and the private right of action created under ICA Section 36(b): the latter right was expressly given by Congress to fund *shareholders*, to sue for recovery of allegedly excessive fees on behalf of the funds they own. By contrast, the implied rescission right found by the Second Circuit is available only to the *parties* to the contract allegedly violating the ICA. Shareholders are not party to any fund-related contracts, such as advisory or other service agreements. And as a general matter, courts have declined to treat an investor's purchase of fund shares pursuant to a prospectus as creating a contract between fund and shareholder. Under this reasoning, there is reason to think that litigation exposure to Section 47(b) rescission claims would be limited to fairly unique circumstances, like those presented in the *Oxford University Bank* case itself.

However, there is one notable outlier case that bears mention. In the Ninth Circuit's much-discussed decision in *Northstar Financial Advisors, Inc. v. Schwab Investments* (2015), the court held that fund shareholders could pursue a breach of contract action against a fund based on the terms of the fund's prospectus and proxy statement. This reasoning has not to date been embraced by other courts outside of the Ninth Circuit. But if this theory of prospectus-as-contract were to gain greater traction, to then be coupled with a contractual rescission right under Section 47(b), it is not difficult to imagine a new swath of creative shareholder claims pursuing new theories as to how fund prospectuses allegedly violate the ICA. Case law developments in this area therefore warrant close attention.