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Investment Company Act Circuit Split Exposes Mutual Funds

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The Investment Company Act of 1940[1] regulates mutual funds, exchange-traded funds and certain other pooled investment vehicles. Since 2002, federal courts have refused to find that implied private rights of action exist under the act. Earlier this month, however, the U.S. Court of Appeals for the Second Circuit held in Oxford University Bank v. Lansuppe Feeder LLC that private plaintiffs may bring actions under Section 47(b) of the act[2] for rescission of contracts that violate the act.

As the Second Circuit recognized, its decision conflicts with several other federal court decisions that have refused to find an implied private right of action under Section 47(b), including a 2012 decision by the U.S. Court of Appeals for the Third Circuit. The U.S. Supreme Court is not expected to have an immediate opportunity to resolve this circuit split, however, because of the new decision's procedural posture.

As a result, participants in the investment company industry — including mutual funds and their boards, sponsors, managers and other service providers — may face increased uncertainty and litigation risk over the next few years if mutual fund investors attempt to bring private actions to rescind contracts that allegedly violate the act. Although these types of suits are unlikely to succeed in the long run, the Second Circuit's decision may make it more difficult to obtain early dismissal.

On Aug. 5, the Second Circuit **held** in Oxford University Bank v. Lansuppe Feeder that "§ 47(b) provides an implied private right of action for rescission."[3] An action for rescission seeks to void a contract and return the parties to their respective positions before they entered into the contract.

The case arose when the senior noteholder in a trust sought to have the trust's assets distributed in accordance with the trust's indenture. Junior noteholders, who would receive nothing under the indenture scheme, argued that the trust violated the Investment Company Act, thereby entitling them to rescind their investment notes under Section 47(b).

The trust was a special-purpose vehicle that did not register as an investment company with the U.S. Securities and Exchange Commission under the act, relying on an exemption for issuers whose securities are only owned by qualified purchasers. The junior noteholders contended that some of the trust's investors were not qualified purchasers under the act and that the trust's failure to register therefore violated the act.

Section 47(b) does not expressly provide for a private right of action. Instead, it states that a contract that is made in, or whose performance involves a, violation of the act "is unenforceable by either party," and that to the extent such a contract has been performed, "a court may not deny rescission at the instance of any party" unless the court finds that it would be inequitable to rescind.

[4]

Generally speaking, only the government and not private actors can enforce federal law.[5] The Second Circuit recognized that under Supreme Court precedent, "private rights of action to enforce federal law must be created by Congress."[6] The Second Circuit also acknowledged that since 2002, numerous federal courts have refused to find that implied private rights of action exist under the act.

Those courts include the Second Circuit itself, which had held in earlier cases[7] that Section 36(a) of the act (which authorizes the SEC to bring actions for breach of fiduciary duty against certain investment company affiliates) and Sections 26 and 27 of the act (which regulate unit investment trusts — another type of pooled investment vehicle — and variable life insurance and variable annuities) did not give rise to private rights of action.

Nevertheless, the Second Circuit concluded that Section 47(b) contained "rights-creating language" because, among other things, it provides that "a party to an illegal contract may seek relief in court on the basis of the illegality of the contract," which "necessarily presupposes that a party may seek rescission in court by filing suit." To the Second Circuit, this "unambiguously evinces Congressional intent to authorize a private action."[8]

The Second Circuit recognized that its decision conflicts with the Third Circuit's decision in Santomenno ex rel. John Hancock Trust v. John Hancock Life Insurance Company,[9] but stated "we do not find the reasoning in Santomenno persuasive."[10] According to the Second Circuit, the Third Circuit ignored the "clear language" in Section 47(b) and improperly resorted to canons of statutory construction only intended to help interpret ambiguous statutory provisions.

The Second Circuit also disagreed with other federal court decisions that concluded that Section 47(b) provides a remedy rather than a substantive right because, according to the Second Circuit, this would read the rescission provision of Section 47(b) out of the statute.

Despite the newly created split between the Second and Third Circuits, the procedural posture of the case means that Supreme Court review of the Second Circuit's decision is highly unlikely. Although the Second Circuit held that an implied private right of action exists under Section 47(b), the court nevertheless affirmed dismissal of the junior noteholders' claim because it concluded that the contract the junior noteholders sought to rescind — the trust's indenture –— did not violate the act.

As a result, despite having lost on the issue of whether Section 47(b) creates an implied private right of action, the senior noteholders won on an alternate ground, and therefore have no basis to seek further appellate review. And the junior noteholders, should they seek to challenge in the Supreme Court the alternate ground on which they lost, will not seek review of a holding they won. So the circuit conflict may exist for some time, during which the Second Circuit decision will presumably govern federal trial courts within its jurisdiction.

Mutual fund investors previously have challenged a variety of conduct under Section 47(b), including Rule 12b-1 plans for paying for mutual fund distribution costs, failures to participate in class action settlements, mutual fund market-timing and late-trading practices, excessive fees paid to mutual fund service providers, and breaches of fiduciary duty under Section 36(a) of the Investment Company Act.

For the past 20 years, none of these claims have succeeded because, among other reasons, courts refused to find a private right of action under Section 47(b). Until the Supreme Court resolves the issue, however, investors and other fund industry participants may seek to bring these and other types of claims that a creative plaintiffs bar can come up with under Section 47(b), at least in federal district courts within the Second Circuit, without having to overcome the defense that no private right of action exists under that section.

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[1] 15 U.S.C. §§80a-1 – 80a-64.

[2] 15 U.S.C. § 80a-46(b).

[3] Oxford Univ. Bank v. Lansuppe Feeder LLC, 2019 U.S. App. LEXIS 23354 (2d Cir. August 5, 2019), at *16.

[4] 15 U.S.C. § 80a-46(b).

[5] See Alexander v. Sandoval, 532 U.S. 275 (2001).

[6] Lansuppe, 2019 U.S. App. LEXIS 23354, at *9 (quoting Sandoval, 532 U.S. at 286).

[7] Bellikoff v. Eaton Vance Corp., 481 F. 3d 110 (2d Cir. 2007); Olmsted v. PruCo Life Ins. Co., 283 F. 3d 429 (2d Cir. 2002).

[8] Lansuppe, 2019 U.S. App. LEXIS 23354, at *12.

[9] 677 F. 3d 178 (3rd Cir. 2012).

[10] Lansuppe, 2019 U.S. App. LEXIS 23354, at *19.
