

Second Circuit Opens Door to Lawsuits Based on Contract Violating 1940 Act

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The Second Circuit has decided that Section 47(b) of the Investment Company Act of 1940 provides a private right of action for rescission of a contract that violates any provision of the 1940 Act or any rule or order thereunder. The decision was handed down in *Oxford University Bank v. Lansuppe Feeder LLC* last August.

The *Oxford* decision conflicts with a Third Circuit decision in *Santomenno v. John Hancock Life Insurance Co.* in 2012. The *Oxford* opinion is thought unlikely to be appealed to the U.S. Supreme Court, which could resolve the conflict between circuits. Until such resolution, contract parties would have the right to sue under Section 47(b) at least in the financially savvy Second Circuit.

Section 47(b), under the Second Circuit's decision, provides for rescission of a contract "by either party" when the contract "is made, or whose performance involves, a violation" of the 1940 Act or "any rule, regulation, or order thereunder." The section 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 1940 Act. The section, however, preserves the "lawful portion of a contract to the extent that it may be severed from the unlawful portion of the contract," as well as any "recovery against any person for unjust enrichment."

Implied private rights of action under the 1940 Act have a convoluted history.

In decades past, courts found implied private rights of action under various sections of the 1940 Act, most importantly under Section 36(a). However, in 2001, the U.S. Supreme Court, in *Alexander v. Sandoval*, laid down a stringent test for finding implied private rights of action under a statute. This caused courts to put the brakes on finding implied private rights of action generally, including under the 1940 Act.

In *Olmsted v. Pruco Life Insurance Co.*, the SEC filed a brief with the Second Circuit advising that Section 47(b) provided a private right of action. However, the court, in 2002, declined to decide the question.

At first blush, the *Oxford* decision may seem to have a limited impact because only a party to a contract can bring an action to rescind it, and investment company shareholders are not parties to many contracts involving investment companies.

However, the Ninth Circuit, in *Northstar Financial Advisors Inc. v. Schwab Investments*, held that fund shareholders could bring a breach of contract action under state law against a fund based on disclosure in the fund's prospectus. Although a subsequent court decision precluded the claim under the Securities Litigation Uniform Standards Act, the intriguing question arises whether a private right of action would lie under Section 47(b) based on disclosure alleged to violate the 1940 Act.

In September 2019, the Second Circuit, in *Edwards v. Sequoia Fund Inc.*, purposefully refused to address the Northstar concept that disclosure can constitute a contract, but assumed the concept for the purpose of finding against the plaintiff. Technically, the Second Circuit left standing the district court's holding that fund disclosure can constitute a contract.

The ramifications of the *Oxford* decision, for both the investment company and the life insurance company industries, are yet to be sorted out.

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