Paul Hastings
StayCurrent
A CLIENT ALERT FROM PAUL HASTINGS
April 2009

More Subprime Fallout: Court Finds Private Right of Action Under Investment Company Act of 1940 for Violation of Investment Objectives

BY GRACE CARTER AND LEE KISSMAN

Overview

In a case of first impression, dealing with a bond fund's investments in collateralized mortgage obligations, a District Court in the Ninth Circuit has ruled that investors (or their investment advisors) may have an implied right of action against a mutual fund under Section 13(a) of the Investment Company Act of 1940 (the "ICA") for deviating from the fund's stated investment objectives. *Northstar Financial Advisors, Inc. v. Schwab Investments, et al.*, No. C 08-4119 SI, 2009 WL 415616 (N. D. Cal., Feb. 19, 2009). Strikingly, the *Northstar* decision represents the first case since 2002 to find an implied private right of action under the ICA. In refusing to dismiss a class action alleging that a fund harmed investors by investing in high-risk mortgage-backed securities, some plaintiffs may claim that the court has opened a new front in the plaintiffs' bar's efforts to capitalize on the subprime crisis through investor class actions.

The court's analysis in *Northstar* stands in sharp contrast to the majority of recent federal court decisions, which have uniformly resisted plaintiffs' calls for private rights of action under numerous sections of the ICA. Taking their cue from analogous Supreme Court cases, these courts hold that if Congress intended to allow private parties to sue for violations of the Act, that intent would have been clearly evidenced. Section 36(b) of the Act, for example, provides an explicit right to sue for investment advisers' breach of fiduciary duties as to fees charged to fund investors. To imply a remedy for *other* sections of the Act, where Congress did not clearly signal an intent to provide one, would be to legislate through litigation.

Not surprisingly, the Schwab defendants in the *Northstar* case have filed a motion for an immediate appeal to the Ninth Circuit and for a stay pending appeal. (Motion to Certify for Interlocutory Appeal and for Stay, filed March 26, 2009, set for hearing May 1, 2009.)

As this alert discusses, fund companies have a number of defenses to plaintiffs' efforts to pursue implied private rights of actions under the ICA, and will continue to argue that, even if allowed to stand, *Northstar's* approach should be limited to the relatively narrow area covered by Section 13(a), including certain deviations from investment policies.

If the plaintiffs' bar were to succeed, however, in persuading other courts to follow *Northstar's* reasoning, the implications could be far-reaching and unwelcome. Courts could find themselves in the business of examining the day-to-day management of funds in order to apply

Section 13(a)'s strictures – such as what investments are being made, how concentrated those investments are in particular industries, and whether the fund's use of a given investment vehicle or strategy diverges sufficiently from the fund's investment policy to support a damages claim.

Allowing mutual funds to be embroiled in court battles with classes of investors over the fund's investment strategies and practices, despite any Congressional authorization of such actions, is not consistent with the last decade of federal court decision-making. Most importantly, allowing such actions flies in the face of Supreme Court rulings that disfavor the creation of any new – and implied – right to sue where Congress has not explicitly shown an intent to provide one.

The Decision in *Northstar v. Schwab Investments*

In *Northstar*, the U.S. District Court for the Northern District of California acknowledged that the issue was one of first impression in the Ninth Circuit, that the burden to show an implied right of action was on plaintiff – and that few if any recent cases in any of the circuits had found an implied right of action under the Investment Company Act of 1940.[1]

Plaintiff Northstar Financial Advisors Inc. filed the case as a class action on behalf of all persons who owned shares of the Schwab Total Bond Market Fund (the "Fund") during the class period. Northstar is a registered investment advisory and financial planning firm that serves institutional and individual clients; it trades through Charles Schwab's Institutional Advisor Platform, and purchased shares in the Fund for its clients. [2]

Northstar alleged that Schwab violated Section 13(a) by deviating from the fund's investment objective to track the Lehman Brothers U.S. Aggregate Bond Index (the "Index") – specifically by investing in high risk non-U.S. agency collateralized mortgage obligations ("CMOs") that were not included in the Index and were significantly more risky than the U.S. agency securities and other instruments comprising the Index.

According to Northstar, the Fund also diverged from its investment objectives by investing more than 25 percent of its total assets in U.S. agency and non-agency mortgage-backed securities and CMOs. (The Fund's objectives did not permit concentration of investments greater than 25 percent in any industry.)

As Judge Susan Illston's opinion states, "Northstar alleges that defendants' deviation from the Fund's investment objective exposed the Fund and its shareholders to tens of millions of dollars in losses due to a sustained decline in the value of non-agency mortgage-backed securities. The Fund's deviation from its stated investment objective caused it to incur a negative total return of 1.09% for the period September 4, 2007 through August 27, 2008, compared to a positive return of 5.92% for the Index over that period." [3]

Finding an Implied Right to Sue

Section 13(a) states in part that no registered investment company may, without a vote of a majority of its outstanding voting securities "deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to section 80a-8(b)(3) of this title."[4]

In *Northstar,* the court's treatment of the cases, pro and con, on private rights of action under Section 13(a) is telling. At the outset, the court rejected out of hand the plaintiff's claim that the Ninth Circuit had already ruled in favor of a private right of action in *Lapidus v. Hecht*, 232 F. 3d 679 (9th Cir. 2000). That issue was never squarely addressed, said the court. But the court was equally dismissive of the defendants' urging that the court should adopt the reasoning of the Second Circuit's decision in *Olmsted v. Pruco Life*

Ins. Co.[5], which found no private right of action under Sections 26(f) and 27(i) of the ICA (dealing with fees charged under variable insurance contracts). One factor relied on heavily in *Olmsted* was that the ICA expressly states that the SEC is charged with enforcement of *all* provisions of the ICA.[6]

The *Northstar* court was not persuaded to adopt *Olmsted* because it was decided before what the court viewed as a key amendment to Section 13. Namely, in December 2007, Congress amended Section 13(c) as part of the Sudan Accountability and Divestment Act to restrict the rights of "persons" to bring actions against a fund or adviser for divesting from securities issued by persons conducting operations in Sudan.

The court reasoned that it is "significant that Section 13(c) expressly limited the types of actions that a 'person' could file under Section 13. If there were no private right of action under Section 13(a), there would be no need to restrict the actions that could be filed under Section 13. . . . [I]f Congress intended for Section 13(c) to operate as a stand alone 'safe harbor' provision, Congress easily could have added Section 13(c) as an entirely new provision of the ICA rather than amending Section 13, or could have stated that there was no private enforcement of Section 13 whatsoever. The fact that Congress only limited certain types of actions suggests that Congress intended that there be a private right of action under Section 13(a)."[7]

The *Northstar* court rejected the argument made by defendants there and in similar cases: that if Congress intended for Section 13(a) to have a private right of action, Congress easily could have added a provision that expressly stated that an investor could sue to recover losses caused by violations of that section. This is exactly what Congress did in providing a private right of action under Section 36(b).[8]

Can *Northstar* Be Squared with Other Cases Analyzing Private Rights of Action?

In point of fact, the decision in *Northstar* represents a return to the reasoning of an older line of authority that more freely found private rights of action under the ICA – or simply assumed that such rights existed. Decisions prior to 2002 had confirmed that investors could sue under various sections of the ICA.[9]

But a sea change occurred when the Supreme Court began delineating a stricter standard for the creation of implied rights of action generally. For example, in *Alexander v. Sandoval*, 532 U.S. 275, 286 (2001), the Supreme Court held that no private right of action existed under disparate impact regulations promulgated under federal civil rights laws. *Sandoval* confirmed that "private rights of action to enforce federal law must be created by Congress," and that a private right can be found only where Congress "displays an intent to create not just a private right but also a private remedy." Seemingly anticipating cases such as *Northstar,* the Supreme Court stated that absent evidence of such Congressional intent, "a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute."[10]

After *Sandoval* was handed down, many courts in addition to *Olmsted* followed its reasoning and refused to divine a private right of action under the Investment Company Act, because Congressional intent was not sufficiently explicit and unequivocal.[11] At least ten cases had refused to imply private rights of action under various sections of the ICA following *Olmsted* and *Sandoval*. The authors of one article state that no case since 2002 has found an implied right of action under any provision of the ICA.[12]

In *Northstar,* the court addressed *Sandoval* only in passing, probably because *Sandoval* did not involve claims under the ICA.[13] But the Supreme Court's reasoning – if not the specific law at issue – is equally applicable to the interpretation of ICA provisions. In particular, *Sandoval* casts doubt on the *Northstar* court's use of the *subsequently* enacted provision in Section 13(c) to suggest that Congress must have intended (sixty-seven years earlier) to provide a private

right to enforce the provisions of Section 13(a).[14]

In light of *Sandoval*,[15] a strong argument can be made that the *Northstar* opinion does not accord with the modern approach to determining whether private rights of action can be allowed. The trend of more recent decisions is to assume that Congress means what it says, and more importantly, says what it means. Where an intent to provide a private right of action is expressly stated, it will be enforced, but not where it is merely gleaned from surrounding provisions or from the absence of an explicit statement to the contrary. That conclusion is dictated by Supreme Court precedent and should not be disregarded.

Attacks on Claimed Private Rights of Action

If the plaintiffs' bar pursues similar claims under the reasoning in *Northstar,* investment companies will have a number of defenses against such implied private rights to sue.

- Nature and scope of the remedy. Defendants can argue that the basic elements of the plaintiffs' claim and the scope of any damages remedy have not been delineated. These elements were not addressed in *Northstar* – because Section 13(a) of the ICA does not explicitly set forth a remedy for private litigants and no court in recent memory has ever found such a right.
- Statute of limitations. Defendants should seek to dismiss any stale claim. But with no stated limitations period, and no guideposts to follow from prior cases, any Section 13(a) remedy could be subject to courts' varying efforts to find and apply an appropriate statute of limitations, no doubt with inconsistent results. The *Northstar* court – apparently finding no other guidance as to the limitations period for a Section 13(a) claim – pointed to the period for a different type of claim entirely, a securities fraud claim under Section 10(b) of the 1934 Act.[16]
- Standing to sue. Defendants should be prepared to attack claims asserted by parties who have no direct injury. The court in *Northstar* granted the Schwab defendants' motion to dismiss the claim for lack of standing, because, as an investment adviser, Northstar had not sufficiently alleged any injury in fact. But the court allowed Northstar to amend and correct the deficiency, either by alleging an assignment of claims from one of Northstar's clients, or by asserting claims in its own right based on the "direct financial injury" the advisor suffered due to the decline in total value of assets under management. It remains to be seen whether *any* viable claim can be stated.
- Direct versus derivative claim. In *Lapidus v. Hecht*, 232 F. 3d 679, 681 (9th Cir. 2000), the court cast doubt on whether any damages claim would be available under Section 13(a), even if a private right of action existed. In any event, such a claim would have to be asserted derivatively rather than as a direct claim.

Conclusion

As noted earlier, the defendants in *Northstar* have filed a motion to certify the decision for an immediate appeal and to stay its enforcement pending a decision on the appeal. In the meantime, investment companies and advisors should be aware that, should other plaintiffs' counsel follow the lead of class counsel in *Northstar,* any lawsuit claiming a private right of action under Section 13(a) would be subject to strong defenses and vulnerable to a motion to dismiss.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Michael Glazer
213-683-6207
michaelglazer@paulhastings.com

Joshua G. Hamilton
213-683-6186
joshuahamilton@paulhastings.com

William F. Sullivan
213-683-6252
williamsullivan@paulhastings.com

Art Zwickel
213-683-6161
artzwickel@paulhastings.com

New York

Domenick Pugliese
212-318-6295
domenickpugliese@paulhastings.com

Michael R. Rosella
212-318-6800
mikerosella@paulhastings.com

Orange County

Jay C. Gandhi
714-668-6242
jaygandhi@paulhastings.com

San Francisco

Julie Allecta
415-856-7006
julieallecta@paulhastings.com

Grace A. Carter
415-856-7015
gracecarter@paulhastings.com

David A. Hearth
415-856-7007
davidhearth@paulhastings.com

Mitchell E. Nichter
415-856-7009
mitchellnichter@paulhastings.com

---

[1] *Northstar*, 2009 WL 415616 at *3, *5. The court first found that the plaintiff investment advisor did not have standing to sue for alleged damage to the investors, but allowed plaintiff to amend to state an injury to support standing. *Id.* at *2, *3.

[2] *Northstar,* 2009 WL 415616 at *1.

[3] *Northstar,* 2009 WL 415616 at *1.

[4] Section 13(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-13(a).

[5] 283 F.3d 429 (2d Cir. 2002).

[6] 283 F.3d at 433, citing Section 42 of the ICA, 15 U.S.C. § 80a-41.

[7] *Northstar,* 2009 WL 415616 at *5.

[8] Section 36(b) says, in relevant part, "*An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company*, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person." (Emphasis added.)

[9] In addition to *Lapidus,* which focused on whether a claim had been stated without ever deciding whether a private right of action existed, the *Northstar* court noted that only two cases, both issued in the 1990's, had explicitly upheld a private right of action under Section 13(a). *Potomac Capital Markets Corp. v. Prudential-Bache Corp. Dividend Fund, Inc.,* 726 F. Supp 87 (S.D.N.Y. 1989); *Blatt v. Merrill Lynch*, 916 F. Supp. 1343 (D.N.J. 1996). But those cases, both in the Second Circuit, were distinguished by the court in *Olmsted* pursuant to *Alexander v. Sandoval*, 532 U.S. 275, 287 (2001), as "belonging to an 'ancien regime' of 'past decisions reflecting judicial willingness to 'make effective [statutory] purpose in the context of implied rights of action.'" [citation omitted.]

[10] *Sandoval,* 532 U.S. at 286-287.

[11] *Olmsted*, 283 F. 3d 429 (2d Cir. 2002); *Bellikoff v. Eaton Vance Corp.,* 481 F.3d 110 (2d Cir. 2007) (no private right of action under Sections 34(b), 36(a) and 48(a) for breaches of duty and failures to disclose involving "shelf space" payments); *In re Merrill Lynch & Co., Inc. Global Technology Fund Securities Litigation,* Master File 02-cv-MDL-1484

(S.D.N.Y. 2003) (no private right of action under Section 34(b) for misstatements in prospectuses and reports to investors); *Stegall v. Ladner,* 394 F. Supp.2d 358, 371 (D. Mass. 2005) (no private right of action under Section 36(a) for breach of fiduciary duty against managers for misconduct); *Mutchka v. Harris*, 373 F. Supp. 2d 1021, 1026-27 (C.D. Cal. 2005) (court finds no private right of action under Section 36(a), noting that Congress's inclusion of an express right of action for Section 36(b) but not for Section 36(a) was "particularly instructive" and "suggests that omission of an explicit private of right to enforce other sections was intentional.").

[12] ALI/ABA, Recent Developments in Litigation Involving Mutual Funds and Investment Advisers 46-54 (May 2008).

[13] *Northstar,* 2009 WL 415616 at *4.

[14] *Sandoval,* 532 U.S. at 291 (noting that Congress cannot be deemed to have "ratified" a private right of action when none of the previously decided cases "establishes (or even assumes) the private right of action at issue here.").

[15] *Sandoval* relied on a line of Supreme Court cases refusing to find private rights of action in other contexts, including *Cort v. Ash,* 422 U.S. 66, 78 (1975) (finding no implied right of action under federal campaign contribution laws); and *Touche Ross & Co. v. Redington*, 442 U.S. 560, 575 (1979) (no implied right of action under section 17(a) of Securities Exchange Act of 1934). Notably, *Cort v. Ash*, 422 U.S. at 78, sets forth a four-part test for determining whether Congress intended to allow private rights of action to enforce a given statutory obligation. The District Court in *Northstar* did not purport to apply, or even address, the four-part test from *Cort v. Ash*.

[16] *Northstar,* 2009 WL 415616 at *8, citing *Betz v. Trainer Wortham & Co.,* 519 F. 3d 863, 874 (9th Cir. 2008).