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The Inadvertent Investment Company: Private Litigation Risk Under the Investment Company Act of 1940

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While the consequences of noncompliance with the Investment Company Act of 1940 can be harsh, companies facing litigation pursuant to it can take heart — the ICA provides for private litigation only in certain limited situations. Moreover, the courts have proven an unfriendly ground for private parties seeking to litigate under the ICA. Despite these limitations, there are still substantial dangers to the ICA that should be considered. This article aims to provide a general overview of the statute, including a brief description of its history, what it covers, how a company can inadvertently become an investment company and the private litigation risk associated with such an occurrence. A basic understanding of the ICA is crucial to avoiding the repercussions of accidentally running afoul of its provisions.

The ICA

Congress enacted the ICA in response to problems faced during the Great Depression. Congress was concerned that traditional investment companies — those that raise funds by selling their own securities and then use those funds to invest in other securities (like traditional mutual funds, for example) — were particularly susceptible to poor oversight and the possibility of unscrupulous management that might misappropriate investors' money.

Congress sought to remedy that by providing for registration and oversight of investment companies by the Securities and Exchange Commission. The ICA provides for ongoing public reporting requirements as well as extensive regulation of virtually all an investment company's activities, including "composition and election of boards of directors, exchange offers, pyramiding, investment policies and types of investments, investment advisory and underwriting contracts, transactions with affiliates, capital structure, custodial arrangements, portfolio evaluation, fidelity bonds, codes of ethics, disclosure of the source of dividends and distributions, proxies, loans, sales and redemptions, repurchases, use of fund assets for distribution, reorganizations, reports to shareholders and the [SEC], books and records, and accountants and auditors."[1]

As this list makes clear, designation as an investment company under the ICA affects virtually every decision a company makes. All of that is well and good when a company has made the conscious decision to become an investment company. But there are a number of companies that do not fit the standard conception of an investment company that inadvertently may become investment companies under the ICA.

For example, some startup companies and companies going through a business model transition may fall within the definition of an investment company during the time that they do not have operating business units. Unless these companies can find an exception or exemption to fit into or receive a declaration from the SEC that they are not required to register as investment companies, the

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repercussions to these so-called "inadvertent investment companies" can be profound.

The Inadvertent Investment Company

The ICA provides three statutory bases for a company to be considered an investment company. Two of the three can be considered "elective" in nature. Whether a company "holds itself out as being engaged primarily … in the business of investing, reinvesting, or trading in securities" or "is engaged … in the business of issuing face-amount certificates of the installment type," both are totally within a company's control.[2]

The third category of investment companies is not limited to those that elect to be covered by the ICA. This category includes any company that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 [percent] of the value of" the company's total assets.[3] If a company meets this definition, it is considered an investment company for purposes of the ICA.

How Does a Company Become an Inadvertent Investment Company?

In theory, there is a two-part test for whether a company can be considered an inadvertent investment company under the ICA:

- Is the company engaged or does it propose to engage in the business of "investing, reinvesting, owning, holding or trading" in securities?; and
- Does the company own "investment securities" whose value exceeds 40 percent of the company's total assets?

In practice, the second question is the only one that matters because holding and owning "investment securities" exceeding 40 percent of a company's total value is sufficient to meet the first test. If a company's investment securities exceed 40 percent of its total value, its answer to the first question must also be "yes."[4] While there are some technical concerns regarding what constitutes an "investment security" and what "value" means, a company can generally determine whether it meets this test by conducting relatively simple arithmetic calculations.

If a company reaches the conclusion that it may fall within the definition of an investment company after making these calculations, it still may avoid the constraints of the ICA if it can fit within one of the statute's numerous exceptions or exemptions. For example, a company is not an investment company under the ICA if:

- All its outstanding securities are owned by a company that has a business purpose other than as an investment company;
- It has fewer than 100 shareholders and does not plan to make a public offering of its securities;
- It is primarily engaged in underwriting and distributing securities issued by other people, selling securities to customers, or acting as a broker and market intermediary;
- It is a bank, insurance company, savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution acting in a trust capacity;
- Substantially all its business is confined to making small loans, industrial banking or similar business;
- Its outstanding securities are owned exclusively by qualified purchasers and it does not plan to make a public offering of its securities;
- It is subject to regulation under the Public Utility Holding Company Act of 1935;
- Substantially all its business consists of owning or holding oil, gas or other mineral royalties or leases; or
- It is a 501(c)(3) tax-exempt organization.[5]

In addition to these exceptions, there also are a number of exemptions outlined in Section 6 of the ICA, including a catch-all exemption: The SEC can conditionally or unconditionally exempt any company from any ICA provision if "necessary or appropriate in the public interest" and "consistent with the protection of investors and the purposes" of the statute.[6]

A company that believes it may have accidentally fallen within the ICA's coverage can also apply to the SEC for a declaration that it is primarily engaged in a business other than that of being an investment company.[7] The filing of an application seeking a declaration that it is not an investment company exempts the applicant from the ICA's requirements for investment companies for at least 60 days, which may be sufficient to make necessary changes to the company's structure to avoid the ICA's coverage.

It is easy to see how a company could accidentally fall under the definition of an investment company, making it unintentionally subject to all the ICA's registration, reporting and other requirements. An inadvertent investment company is faced with a dilemma: Comply

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with the ICA's registration requirements and subject itself to the substantial burden of ongoing compliance with the ICA (despite the fact that it has no intention of conducting the "business" of a traditional investment company) or opt not to register (potentially subjecting itself to both SEC action and civil litigation from opportunistic plaintiffs) and seek to restructure its business in such a way as to remove itself from the ICA's coverage as quickly as possible. Of course, due to the ICA's limitations on the types of transactions that unregistered investment companies can participate in, even an attempt to escape from the ICA may be prohibited by the statute.

Why Being an Inadvertent Investment Company Matters

After determining whether it is subject to the ICA's registration requirements and SEC oversight, an inadvertent investment company must also consider the possibility of an SEC enforcement action or private litigation under the ICA. Most of the ICA's provisions are expressly applicable only to "registered" investment companies and therefore do not apply to inadvertent investment companies. Still more of those sections that are applicable to unregistered investment companies discuss only SEC enforcement options. There are only a few ICA provisions that could allow for private litigation against an inadvertent investment company (Sections 7, 8, 47 and 48), all of which are discussed in this article.

Section 8 is the most fundamental of the ICA provisions that apply to inadvertent investment companies. It requires all investment companies to register with the SEC.[8] Section 7 works in tandem with Section 8. It prohibits transactions by companies that are subject to the ICA but have not registered as investment companies.[9] Specifically, an unregistered investment company cannot:

- Offer for sale, sell or deliver after sale any security or any interest in a security;
- Purchase, redeem, retire or otherwise acquire or attempt to acquire any security or any interest in a security;
- Control an investment company that engages in any of these activities;
- Engage in any business in interstate commerce; or
- Control any company that is engaged in any business in interstate commerce.[10]

In short, Section 7 prohibits an unregistered investment company, inadvertent or otherwise, from engaging in commerce until it registers. Section 47 gives Section 7 its teeth in the courtroom. Specifically, it provides that a contract "that is made or whose performance involves a violation of this title … is unenforceable by either party … unless a court finds that under the circumstances enforcement would produce a more equitable result than non-enforcement."[11]

Finally, Section 48 creates liability for people who control investment companies for any violation of the ICA.[12] None of these provisions has been heavily litigated, making this an area open for interpretation by the courts. A brief exploration of the few judicial opinions discussing these sections provides some guidance on the potential limitations of private litigation against inadvertent investment companies under the ICA and the remedies available to plaintiffs bringing such claims.

Private Litigation by Contractual Parties

People who contract with inadvertent investment companies have the option to sue under Section 47. Those cases involving private litigation by contractual parties under Section 47 generally involve a discussion of two standing-related issues: whether there is an independent underlying violation of the ICA that the suit is based on and whether that underlying provision provides a private right of action.

Independent Violation of the ICA

Section 47 provides a remedy, not an independent cause of action. In other words, a party can seek the remedies set forth in Section 47 only if there is another independent violation of the ICA.[13] Moreover, at least one court has concluded that Section 47 applies only to contracts that are entirely unlawful. For Section 47 to apply, the court reasoned, the ICA violation must be "inseparable from performance" of the contract sought to be rescinded. But if the violation is only "collateral or tangential" to the parties' contract, there is no cause of action under Section 47.[14] Arguably, however, *any* contract entered into by an inadvertent investment company is inherently unlawful under Section 7, automatically providing a party to that contract with a potential cause of action under Section 47.

Private Right of Action

For a claim pursuant to Section 47, a plaintiff also must have a private right of action under the other ICA provision that allegedly has been violated. There are only a few sections of the ICA that expressly contemplate a private right of action, and none of those (apart from Section 47) is applicable to inadvertent investment companies. But the fact that the ICA does not expressly provide for private litigation does not end the analysis.

The question of implied private rights of action under the ICA has been addressed by a number of courts in recent years. While many early decisions under the ICA were quick to presume that there were private litigation rights, most courts have since been hesitant to find that such rights exist. Under modern U.S. Supreme Court precedent, implied rights of action are increasingly disfavored, making this a strong potential defense to any claim brought pursuant to the ICA. Importantly, though, some courts have concluded that there is a private right of action under Section 7 despite that section's silence on the question.[15]

Private Litigation by Shareholders And Other Nonparties

While Section 47 grants standing to parties to contracts to litigate in certain situations, there also is the potential for private litigation under the ICA by shareholders of an inadvertent investment company and what can be called "knowledgeable nonparties" under Section 47.

Shareholder Litigation

Many of the courts addressing claims brought by shareholders pursuant to the ICA have concluded that such claims must be brought derivatively.[16] That is particularly true with respect to claims under Section 47 because it expressly limits standing to knowledgeable nonparties.or those who are parties to a contract. [17] Because a shareholder meets neither definition, any claim it has pursuant to Section 47 must be derivative in nature.

Making Section 47 claims by shareholders derivative dramatically increases the burden on a shareholder bringing the lawsuit by making the litigation subject to the constraints of the business-judgment rule and other similar limitations of derivative litigation. Moreover, any recovery would go to the company rather than the plaintiff itself, further disincentivizing frivolous lawsuits.

At least one court has concluded that a shareholder has a private cause of action for damages under Section 8 of the ICA, which requires investment companies to register with the SEC.[18] A shareholder does not have standing, however, to seek to force an unregistered investment company to register with the SEC.[19]

Knowledgeable Nonparty Litigation

Generally speaking, nonparties to contracts lack standing under Section 47.[20] But Section 47 also provides certain nonparties to contracts with the right to challenge those contracts under the ICA. Specifically, a nonparty "who acquired a right under the contract with knowledge of the facts by reason of which the making or performance violated or would violate any provision" of the ICA also has standing under Section 47 to seek to invalidate a contract.

The ICA provides no guidance on how one becomes such a knowledgeable nonparty, and the courts have not answered this question. The only court to discuss the issue of knowledgeable-nonparty standing in any detail said plaintiffs must do more than "simply declare themselves 'a nonparty who acquired rights under a contract'" and concluded that merely being a shareholder in a company was not sufficient to create knowledgeable-nonparty status.[21]

Liability of Control Persons

Section 48 says it is unlawful for any person "directly or indirectly" to cause another person to violate the statute.[22] Like Section 47, Section 48 predicates liability on some other violation of the ICA.[23] Nothing in the statute affirmatively provides for a private right of action under Section 48, subjecting it to the "implied right of action" analysis previously discussed. Indeed, the U.S. Court of Appeals for the 2nd Circuit recently has ruled that there is no private right of action under Section 48.[24]

Remedies

If a contract subject to Section 47 has been performed, a court can order rescission at the request of any party unless equity would prevent rescission.[25] At least one court has concluded that the minimum remedy available pursuant to Section 47 is rescission of the offending contract.[26]

With regard to contracts that have yet to be fully performed, courts have construed Section 47 as allowing lawsuits to have a contract declared void, seek damages or have continued performance of the contract enjoined.[27] Section 47 provides that a contract that violates the ICA is "unenforceable" by the parties. There is some confusion about the meaning of the word "unenforceable." The previous wording of Section 47 included the word "void" rather than "unenforceable." Rules of statutory interpretation, then, would suggest that unenforceable means voidable, rather than void. Even under the old wording, there was an argument to be made that contracts violating the ICA were merely voidable.[28] While this is another open issue under the statute, the weight of the authority supports a reading of "unenforceable" as "voidable."

Finally, the remedies available to knowledgeable nonparties under Section 47 also are unclear. While knowledgeable nonparties are given standing in that part of Section 47 making contracts violating the ICA "unenforceable," the statute's language limits rescission to actions by "any *party*." While no court has ruled on this issue, the language of the ICA itself calls into question whether a knowledgeable nonparty can seek to rescind a contract to which it is not a party or will be limited to damages.

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Conclusion

A company that arguably falls under the definition of an investment company under the ICA and cannot meet the requirements of one of the exemptions from coverage may be subject to private litigation by counterparties to its contracts, shareholders and certain knowledgeable third parties. If these people can establish that the ICA applies and that the company failed to register, its contracts may be subject to rescission and it may be subject to damages. Moreover, the SEC may get involved if it is made aware of the private litigation, subjecting the company to potential government enforcement action.

Knowledge of the ICA's coverage, limitations on the actions available pursuant to it and the damages available will help companies avoid the pitfalls facing the inadvertent investment company in private litigation.

Notes

[1] Securities and Exchange Commission, Request for Comments on Reform of the Regulation of Investment Companies, Release No. IC-17534, 1990 WL 320723 (June 15, 1990).

[2] *See* 15 U.S.C. § 80a-3(a)(1)(A)-(B) (Thomson/West 2007).

[3] *Id.* at § 80a-3(a)(1)(C).

[4] In re Atl. Coast Line Co., Release No. IC-366, 1942 WL 34866 (June 15, 1942) (finding investment company that had been inactive for 24 years still was engaged in the business of investing, reinvesting, owning, holding or trading in securities because it owned more than 40 percent).

[5] There are a number of other exceptions from the ICA's coverage. *See* 15 U.S.C. § 80a-3.

[6] 15 U.S.C. § 80a-6.

[7] *Id.* § 80a-3(b)(2).

[8] *Id.* § 80a-8(e).

[9] *Id.* § 80a-7(a).

[10] *Id.*

[11] 15 U.S.C. § 80a-46(b)(1).

[12] *Id.* § 80a-47.

[13] *Stegall v. Ladner,* 394 F. Supp. 2d 358, 378 (D. Mass. 2005).

[14] *In re Mut. Funds Inv. Litig.,* 384 F. Supp. 2d 873, 880 (D. Md. 2005).

[15] *Blatt v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 916 F. Supp. 1343, 1349 (D.N.J. 1996).

[16] *See, e.g., Moses v. Black*, No. 78 Civ. 1913, 1981 WL 1599 (S.D.N.Y. Feb. 3, 1981) (assuming without deciding that a shareholder in an unregistered investment company has standing to assert derivative claims); *but see, e.g., Strougo v. Bassini,* 282 F.3d 162, 177 (2d Cir. 2002) (applying Maryland law to determine that derivative action not required to assert violations of Section 48).

[17] *Lessler v. Little*, 857 F.2d 866, 874 (1st Cir. 1988); *Hamilton v. Allen*, 396 F. Supp. 2d 545, 558 (E.D. Pa. 2005).

[18] *Krome v. Merrill Lynch & Co. Inc.,* 637 F. Supp. 910, 918 (S.D.N.Y. 1986).

[19] *M.J. Whitman & Co. Inc. Pension Plan v. Am. Fin. Enters.*, 552 F. Supp. 17, 22 (S.D. Ohio 1982), *aff'd,* 725 F.2d 394 (6th Cir. 1984).

[20] *See Davis v. Bailey*, No. 05-CV-00042, 2005 WL 3527286, at *6 (D. Colo. 2005); *Lessler*, 857 F.2d at 874.

[21] *Highland Crusader Offshore Partners L.P., v. Motient Corp.*, No. A-06-CA-540-LY, 2006 WL 3358425, at *9 (W.D. Tex. Nov. 17, 2006).

[22] 15 U.S.C. § 80a-47(a).

[23] *See, e.g., In re Dreyfus Mut. Funds Fee Litig.*, 428 F. Supp. 2d 357, 360 (W.D. Pa. 2006).

[24] *Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 117 (2d Cir. 2007).

[25] 15 U.S.C. § 80a-46(b)(2).

[26] *Carr v. Equistar Offshore Ltd.*, No. 94 Civ. 5567, 1995 WL 562178, *14 (S.D.N.Y. Sept. 21, 1998).

[27] *Blatt*, 916 F. Supp. at 1349.

[28] *Green v. Brown*, 276 F. Supp. 753, 757 (S.D.N.Y. 1967).

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