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Client Alert

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Just How Close of a "Connection" is Required? The Supreme Court Will Review the Scope of SLUSA's Preclusive Effect on State Securities Class Actions

"In granting certiorari, the Supreme Court will determine whether SLUSA precludes a state law class action where plaintiffs are induced to invest in securities that are not covered by SLUSA but where the underlying fraudulent scheme involves ... covered securities."

The Supreme Court has granted certiorari in three consolidated cases arising from the R. Allen Stanford Ponzi scheme to clarify when an alleged misrepresentation is "in connection with" a securities transaction within the meaning of the Securities Litigation Uniform Standards Act (SLUSA).[1] At issue is the scope of SLUSA's provision that precludes class actions based on state law that involve "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security."[2] Seeking to resolve a lack of uniformity among the Circuit Courts of Appeals, the Supreme Court will address "whether SLUSA precludes a state-law class action alleging a scheme of fraud that involves misrepresentations about transactions in SLUSA-covered securities."[3]

SLUSA's Origins

In 1995, because of "perceived abuses of the class-action vehicle in litigation involving nationally traded securities," Congress enacted the Private Securities Litigation Reform Act (PSLRA). The PSLRA's provisions "limit recoverable damages and attorney's fees, provide a 'safe harbor' for forward looking statements, impose new restrictions on the selection of (and compensation awarded to) lead plaintiffs, mandate imposition of sanctions for frivolous litigation, … authorize a stay of discovery pending resolution of any motion to dismiss" and impose "heightened pleading requirements in actions brought pursuant to [Securities Exchange Act] § 10(b) and [Securities and Exchange Commission] Rule 10b-5."[4] When Congress convened hearings to evaluate the effects of the PSLRA a few years later, Congress found that "[r]ather than face the obstacles set in their path by the [PSLRA], plaintiffs and their representatives began bringing class actions under state law, often in state court."[5]

In 1998, Congress enacted SLUSA to "stem this 'shif[t] from Federal to State courts' and 'prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of'" the PSLRA.[6] SLUSA bars plaintiffs from bringing a class action on behalf of more than 50 persons under state law alleging misrepresentations "in connection with" nationally traded or registered securities.[7] In so doing, SLUSA prevents plaintiffs from side-stepping the requirements of the

PSLRA by artfully pleading what are essentially federal securities claims under the guise of state common law.

Plaintiffs' Allegations

The consolidated cases the Supreme Court will hear stem from the multi-billion dollar Ponzi scheme operated by R. Allen Stanford and the entities he controlled. One such entity, an Antigua-based bank, issued fixed-return certificates of deposits (CDs) purchased by plaintiffs through their individual retirement accounts (IRAs).[8] The bank allegedly represented that the CDs were backed by liquid securities, and would be safe investments that generated above-market returns.[9] Instead of investing the funds generated by the CD sales to acquire the promised securities, however, the bank allegedly used the proceeds to make interest and redemption payments on pre-existing CDs.[10] After the fraud was uncovered in 2009, plaintiffs alleged violations of Texas and Louisiana common law and securities laws against the issuing bank, as well as insurance brokers and financial service entities that marketed the CDs. Plaintiffs further alleged that the bank's law firms aided and abetted the scheme by making misrepresentations to the SEC that helped Stanford and his corporate entities evade regulatory oversight.[11] The cases were consolidated in federal district court in the Northern District of Texas, and defendants moved to dismiss or remand on the basis that SLUSA precluded the lawsuits.[12]

Plaintiffs argued that SLUSA did not apply because the fraud was "in connection with" the sale of the CDs, which were never registered or nationally traded and therefore were not "covered securities" for SLUSA purposes.[13] Defendants argued for a broader interpretation of "in connection with" that would encompass (i) the securities that were claimed to have backed up the CDs and (ii) securities that some plaintiffs may have sold to fund their purchase of CDs. According to defendants, SLUSA barred the plaintiffs' claims because plaintiffs alleged that they were induced to purchase the CDs by defendants' misrepresentations that they were backed by a diversified portfolio of covered securities, and because some investors sold covered securities to fund their purchase of CDs.

Lower Court Opinions

The district court, reasoning that the Supreme Court had urged a broad interpretation of the "in connection with" requirement in order to further SLUSA's policy goals, agreed with defendants and held that SLUSA precluded the lawsuit.[14] Adopting the test articulated by the Eleventh Circuit, the district court held that plaintiffs' state law claims were precluded because they were based on "fraud that induced [the plaintiffs] to invest" in covered securities.[15] The court noted the CDs' promotional materials emphasized that the underlying portfolio was invested in "highly marketable securities issued by stable governments, strong multinational companies and major international banks."[16] Further, the fact that at least some plaintiffs had likely financed the CD purchase by selling other SLUSA-covered securities in their IRAs provided an independent rationale for SLUSA preclusion.[17]

The Fifth Circuit reversed. First, the court surveyed the standards articulated by the Circuits. The Second, Sixth, Seventh, Eighth and Eleventh Circuits have held that fraud allegations that "depend on" or "necessarily allege, involve or rest" on transactions in covered securities satisfy the "in connection with" requirement.[18] The Ninth Circuit, in contrast, has adopted a narrower interpretation, holding that fraud is "in connection with" the purchase of sale of securities if there is "a relationship in which the fraud and the stock sale coincide or are more than tangentially related."[19]

The Fifth Circuit embraced the Ninth Circuit's view, finding that Supreme Court precedent and policy and legislative intent considerations "militate[d] against an overbroad formulation."[20]

Applying that test, the Fifth Circuit concluded that SLUSA did not preclude respondents' claims, because "the heart, crux, and gravamen of [the] allegedly fraudulent scheme" involved the representation "that the CDs were a safe and secure investment."[21] The claim that the proceeds from the sales of CDs were invested in a portfolio including SLUSA-covered securities was but one of a host of misrepresentations made to plaintiffs in the attempt to lure them into buying the worthless CDs.[22] Consequently, securities transactions were "not more than tangentially related to [the] scheme."[23]

In addition, the Fifth Circuit found that the sale of covered securities by some plaintiffs to finance the purchase of CDs created only a tangential relationship between the fraud and covered securities because defendants did not convince the victims to sell those securities.[24] The court further noted that "construing SLUSA to depend on the source of funds…leads to absurd results," such as allowing two virtually identical claims to be treated differently under SLUSA depending on the methods used by plaintiffs to raise money to buy the securities.[25] Likewise, SLUSA did not preclude the aiding and abetting claims against the law firm defendants. Those claims — that the law firms made misrepresentations to the SEC that effectively stalled the Commission's investigation into Stanford and obstructed the SEC's ability to uncover the fraud and block the harm to plaintiffs — were several steps removed from the misstatements made by the corporate defendants to plaintiffs, and therefore were not more than "tangentially related" to the purchase or sale of covered securities.[26]

The Government Weighs In

Defendants petitioned the Supreme Court for certiorari, and the Solicitor General, at the invitation of the court, filed an amicus brief opposing a grant of certiorari. The government argued that the Courts of Appeals had not applied substantively different understandings in assessing SLUSA preclusion, and that none of the decisions of those courts was in direct conflict with the conclusion reached by the Fifth Circuit.[27] The government also contended that the case presented an unusual factual circumstance: defendants had made false representations concerning their holdings in SLUSA-covered securities for the purpose of inducing plaintiffs to invest in uncovered securities. Thus, the Supreme Court's holding in this case would be of little assistance to lower courts that more commonly grapple with defendants' misrepresentations about a covered security in order to induce a transaction in that security.[28]

In granting certiorari, the Supreme Court will determine whether SLUSA precludes a state law class action where plaintiffs are induced to invest in securities that are not covered by SLUSA but where the underlying fraudulent scheme involves the purchase or sale of covered securities.[29] If the Court affirms the Fifth Circuit's decision, plaintiffs may increasingly bring state law claims based on investment vehicles that are not covered securities themselves but whose performance implicates covered securities, such as hedge funds and other investment funds that invest in nationally traded equities, options or debt instruments. Likewise, investment managers and entities that market such investments may face an increased risk of liability. By contrast, if the Supreme Court reverses the Fifth Circuit, financial services defendants will have greater success in obtaining the dismissal of class action lawsuits predicated on violations of state law. Plaintiffs will be forced instead to file federal securities lawsuits that meet the stricter pleading requirements imposed by the PSLRA.

Endnotes

[1] The three consolidated cases are *Chadbourne & Parke v. Troice, et al.*, No. 12-79, *Willis of Colorado v. Troice, et al.*, No. 12-86 and *Proskauer Rose v. Troice, et al.*, No. 12-88.

[2] 15 U.S.C. § 78bb(f)(1)(A).

[3] *Roland v. Green*, 675 F.3d 503 (5th Cir. 2012), *cert. granted in part by Chadbourne & Parke LLP v. Troice*, 2013 WL 203548, 81 USLW 3067 (U.S. Jan. 18, 2013) (No.12-79), *and cert. granted in part by Willis of Colorado v. Troice, et al.*, 2013 WL 203549, 81 USLW 3067 (U.S. Jan. 18, 2013) (No. 12-86), *and cert. granted in part by Proskauer Rose LLP v. Troice*, 2013 WL 203550, 81 USLW 3067 (U.S. Jan. 18, 2013) (No. 12-88).

[4] *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 81 (2006).

[5] *Id*.

[6] *Id*., quoting SLUSA §§ 2(2), (5), 112 Stat. 3227.

[7] *See* 15 U.S.C. § 78bb(f)(1)(a).

[8] *Roland v. Green*, 675 F.3d at 508-09.

[9] *Id*.

[10] *Id*. at 508.

[11] *Id*. at 509-10.

[12] *Id*.

[13] *See* 15 U.S.C. § 77r(b); *see also id*. at 510.

[14] 675 F.3d at 510.

[15] *Id*.

[16] *Id*.

[17] *Id*. at 510-11.

[18] *See id*. at 512 discussing *Romano v. Kazacos*, 609 F.3d 512, 522 (2d Cir. 2010) (SLUSA precludes state law claims that “necessarily allege,” “necessarily involve,” or “rest on” the purchase or sale of securities); *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 310 (6th Cir. 2009) (SLUSA precludes fraud claims that “depend on” transactions involving covered securities); *Gavin v. AT&T Corp*., 464 F.3d 634, 639 (7th Cir. 2006) (fraud must “involve[e]” covered securities); *Siepel v. Bank of Am*., N.A. 526 F.3d 1122, 1127 (8th Cir. 2008) (SLUSA precludes fraud claims that “depend on” transactions involving covered securities”); *Instituto De Prevision Militar v. Merrill Lynch*, 546 F.3d 1340, 1349 (11th Cir. 2008) (SLUSA precludes state law fraud class actions when the fraud allegedly “induced [plaintiffs] to invest with [defendants]” or a “fraudulent scheme…coincided and depended upon the purchase or sale of [covered] securities”) .

[19] *Madden v. Cowen & Co*., 576 F.3d 957 (9th Cir. 2009)

[20] *Id*. at 519-20.

[21] *Id*. at 522.

[22] *Id*. at 521.

[23] *Id*. at 523.

[24] *Id*. at 523.

[25] *Id*. at 523, n. 7.

[26] *Id*. at 524-25.

[27] *Chadbourne & Parke LLP v. Troice*, 2012 WL 3866481 at *13 (Appellate Petition, Motion and Filing) (U.S. Dec. 19, 2012) (Nos. 12-79, 12-86, 12-88).

[28] *Id*. at 11-12.

[29] The Supreme Court did not grant certiorari to the question of whether SLUSA precludes class actions asserting that defendants aided and abetted SLUSA-covered securities fraud when defendants themselves did not make misrepresentations about the purchase or sale of SLUSA-covered securities.

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