To: Our Clients and Friends March 7, 2014

U.S. Supreme Court Limits Scope of SLUSA's Preclusion of Securities Class Actions for Violations of State Law Where Fraudulent Scheme Did Not Directly Involve Plaintiffs' Purchase or Sale of "Covered" Securities

In *Chadbourne & Parke LLP v. Troice*, decided February 26, 2014, the U.S. Supreme Court held that class actions arising out of the multibillion-dollar Ponzi scheme run by investor Allen Stanford could proceed in state court, and were not prohibited by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). SLUSA prohibits state-law class actions that allege fraud "in connection with" the purchase or sale of securities traded on national exchanges. Stanford's scheme entailed selling certificates of deposit ("CDs") in a bank, which claimed to purchase valuable assets to backstop the CDs. Although the CDs themselves were not "covered" securities, the bank's purported assets included "highly marketable securities issued by stable governments [and] strong multinational governments," including an unspecified and unknown collection of "covered securities" within the meaning of SLUSA. In *Troice*, the U.S. Supreme Court decided by a vote of 7-2 that there was an insufficient direct relationship between the fraudulent scheme and the required purchase or sale of "covered" securities to trigger SLUSA. Justice Breyer wrote for the seven-member majority, with a separate concurrence by Justice Thomas, while Justices Kennedy and Alito dissented.

The Statutory Scheme – And Why* Troice *Matters

Under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, private individuals may seek damages for misrepresentations or omissions committed "in connection with" the purchase or sale of any "security." For purposes of § 10(b) and Rule 10b-5, a "security" includes not only securities traded on national exchanges, but also any *other* stocks, bonds, futures, swaps, debentures, and CDs. The private right of action exists in addition to civil enforcement powers granted to the SEC, as well as the ability of the Department of Justice to bring criminal prosecutions based on these laws.

Section 10(b) and Rule 10b-5 do not permit private individuals to bring lawsuits against secondary actors for "aiding and abetting" securities fraud, and are subject to a variety of other limitations on claims that make federal rights of action more difficult to plead and prove than state claims. Most notably, in 1995, Congress passed the Private Securities Litigation Reform Act ("PSLRA"), which imposed restrictions on federal securities fraud claims. To avoid these federal restrictions, private plaintiffs began increasingly to pursue class actions based on state-law claims – such as breach of fiduciary duty, breach of contract, or common-law fraud. In response, Congress passed SLUSA in 1998, forbidding private citizens from bringing certain class actions lawsuits based on securities fraud claims that arise under state (not federal) law.

SLUSA was tailored to affect only state-law class actions asserting misrepresentations and omissions "in connection with" the purchase or sale of "covered" securities. To a large extent, this language closely tracks the language of § 10(b) and Rule 10b-5. Under SLUSA, however, Congress has defined "covered" securities to include primarily securities that are listed, or authorized for listing, on a national securities exchange. When it applies, SLUSA offers substantial protections to parties defending class actions, including the right to remove a state-court class action to federal court for immediate dismissal of the class claims. For parties who are alleged to be aiders and abettors of the wrongdoing, SLUSA uniquely insulates these defendants from the expense and exposure of state-law class actions. SLUSA also prevents plaintiffs from making end-runs to evade the PSLRA's limitations in state court.

The Class Action Lawsuits

Troice concerned four class action lawsuits filed against various parties—including investment advisers, insurance brokers, and law firms—who had worked with Allen Stanford and Stanford International Bank (the "Bank") during the course of Stanford's Ponzi scheme. The lawsuits asserted violations of state law focusing on the sale of CDs in the Bank that Stanford misrepresented as being backed by the Bank's investments in "safe, secure, and liquid" assets, including nationally traded securities. The lawsuits allege that, in reality, the Bank had not maintained a stable portfolio of investments due to the ongoing Ponzi scheme, which involved using the funds to repay old investors and finance Stanford's personal luxuries. The plaintiffs allege that the stability of the Bank's investment portfolio had served as a key factor in their decisions to purchase the Bank's CDs. According to the lawsuits, each defendant had been a secondary actor who either assisted Stanford in perpetrating this fraud or in concealing the fraud from regulators.

The parties agreed that the actual CDs purchased by the plaintiffs were not listed on national exchanges and therefore were not "covered securities" under SLUSA. The defendants argued, however, that the Bank's alleged misrepresentations were nevertheless "in connection with" the purchase or sale of covered securities under SLUSA because the Bank had informed the plaintiffs that the CDs were backed by the Bank's own investment in nationally traded securities. Based on these arguments, the defendants removed two Louisiana state court cases to Louisiana federal court, which were later consolidated with two other cases in Texas federal court. The district court agreed with the defendants and dismissed the class claims. The U.S. Court of Appeals for the Fifth Circuit reversed the district court and reinstated the cases with instructions to remand the Louisiana class actions to state court and to permit the class actions filed in federal court to proceed.

The Supreme Court's Decision

In an opinion authored by Justice Breyer and joined by six other Justices, the Supreme Court concluded that a misrepresentation or omission is not "in connection with" the purchase or sale of a covered security unless it is material to a decision by someone *other than the "fraudster"* to buy or sell a covered security. Hence, because none of the Stanford victims had purchased, sold, or abstained from selling a "covered security," SLUSA did not apply. This seemingly straightforward application of the statutory language became less straightforward in light of prior caselaw, particularly *Merrill Lynch, Pierce Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006), where the Supreme Court unanimously held that SLUSA was to be given a "broad" reading to include misrepresentations or omissions that "coincided" with a purchase or sale of a covered security. This interpretation meshed with prior decisions concerning the "in connection with" language found in § 10(b) and Rule 10b-5. *See United States v. O'Hagan*, 521 U.S. 642, 651 (1997); *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 10 (1971). The language of *Dabit* and its predecessors was sweeping, but despite these broad statements, none of these cases had applied SLUSA to a scenario where the fraud did not actually involve "victims who took, who tried to take, who divested themselves of, who tried to divest themselves of, or who maintained *an ownership interest* in financial instruments that fall within the relevant statutory definition" of "security" or "covered security." The majority emphasized that this holding was consistent with its precedent; the dissent cited nothing to the contrary. In making the plaintiffs' "ownership position" the focal point of these laws, the majority also rejected a proposal by the dissent that the phrase "in connection with" should encompass purchases or sales that merely "enable" the fraud.

Troice does not overturn or otherwise limit prior cases, particularly *Dabit*. Indeed, the Court said specifically that "[w]e do not here modify *Dabit*," which is consequential, since *Dabit* was the leading authority causing many Circuit Courts to read SLUSA in an expansive fashion. *See, e.g.*, *Atkinson v. Morgan Asset Management, Inc.*, 658 F.3d 549 (6th Cir. 2011); *Romano v. Kazacos*, 609 F.3d 512 (2d Cir. 2010); *Madden v. Cowen & Co.*, 576 F.3d 957 (9th Cir. 2009); *Siepel v. Bank of America, N.A.*, 526 F.3d 1122 (8th Cir. 2008); *Instituto De Prevision Militar v. Merrill Lynch*, 546 F.3d 1340 (11th Cir. 2008). It thus should have no effect on cases such as *Mandelbaum v. Fiserv, Inc.*, 787 F. Supp. 2d 1226 (D. Colo. 2011), where SLUSA was applied to bar class actions arising out of the Madoff Ponzi scheme, where the claimants had each believed Madoff was purchasing covered securities on their behalf – but he was not doing so.

The *Troice* dissent argued that the "new" reading of SLUSA – again, whose language is modeled on § 10(b) and Rule 10b-5 – would mean that SEC enforcement powers might be constrained, and that new and sophisticated frauds might escape federal regulatory or private civil enforcement. The majority disputed the novelty of its interpretation of the phrase "in connection with" by stressing that, while the Court's vocabulary may have changed, the outcomes of prior Supreme Court cases would have remained the same. The majority also disputed whether any prior SEC enforcement action would have been affected by the rule being announced. Finally, the majority dismissed the notion that civil enforcement might be limited, given that permitting state class claims to proceed substantially encourages prosecution of claims against parties shielded by current federal securities laws standards.

Troice thus opens the door to state court class actions involving certain types of frauds, where the relationship between the fraud and any transactions in covered securities is not immediate and direct. Whether this will ultimately affect federal regulatory authority remains to be seen. It cannot be doubted, however, that *Troice* has opened the door a little wider for aider-and-abettor and co-conspirator liability for parties alleged to have been complicit in securities fraud. .

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