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Supreme Court Considers Scope of Preclusion of State Law Securities Fraud Class Action Litigation Under the Federal Securities Litigation Uniform Standards Act

October 10, 2013

On Monday, October 7, the first day of the new term, the Supreme Court heard oral arguments in *Chadbourne & Parke LLP v. Samuel Troice* in which the Court is expected to clarify the scope of preclusion under the Securities Litigation Uniform Standards Act ("SLUSA") of state-law securities fraud class actions. SLUSA precludes state-law fraud class actions to the extent they are "in connection with" SLUSA-covered securities. The Court will likely resolve a circuit split and determine when an alleged misrepresentation is sufficiently related to the purchase or sale of a covered security to satisfy the "in connection with" requirement for SLUSA to preclude state-law class actions.

BACKGROUND AND CIRCUIT SPLIT

In 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA") to combat issues such as nuisance filings, targeting of specific clients, and client manipulation in class action suits. The PSLRA made it significantly more difficult to bring securities class actions in federal court. However, the PSLRA had the unintended consequence of prompting plaintiffs' attorneys to avoid federal forums and file class actions in state court instead.

In 1998, Congress enacted SLUSA, 15 U.S.C. § 78bb(f)(1)(A), to prevent PSLRA-evading plaintiffs from filing class action fraud suits in state courts. Among other things, SLUSA made federal courts the exclusive venue for securities class action lawsuits "in connection with" the purchase or sale of a covered security. A covered security is a security traded on a national exchange or issued by a federally registered investment company. SLUSA requires dismissal or removal of class action suits in connection with covered securities.

In its 2006 ruling in *Merrill Lynch v. Dabit*, the Supreme Court articulated a broad scope for the "in connection with" requirement, holding that securities-fraud claims brought by those who never purchased or sold a covered security satisfy the requirement if the underlying allegations of fraud "coincide" with a covered securities transaction by the plaintiff or someone else.

Nevertheless, the circuits are divided over how broad the scope should be for the "in connection with" requirement. The Ninth and Fifth Circuits more narrowly interpret the "in connection with" requirement. According to the Ninth Circuit in

The Report From Washington is published by the Washington, D.C. office of Simpson Thacher & Bartlett LLP.

Madden v. Cowen & Co., "[a] misrepresentation is 'in connection with' the purchase or sale of securities if there is a relationship in which the fraud and the stock sale coincide or are *more than* tangentially related." If the alleged fraud is only "tangentially related" to a covered securities transaction, SLUSA preclusion does not apply.

The Second, Sixth, and Eleventh Circuits employ broader standards for construing the "in connection with" requirement and thus generally would preclude more cases than the approach taken in the Fifth and Ninth Circuits. For example, the Eleventh Circuit, in *IPM v. Merrill Lynch*, held that a misrepresentation is made "in connection with" a covered securities transaction if it "*induced* [plaintiff] to invest with [defendant]," or the misrepresentation "coincided and depended upon the purchase or sale of securities."

THE TROICE CASE

The three consolidated cases before the Supreme Court arise from the massive alleged Ponzi scheme perpetrated by R. Allen Stanford and entities under his control. Stanford entities allegedly sold certificates of deposit by promising above-market returns and falsely assuring investors that the CDs were backed by safe investments, including securities covered by SLUSA. However, the CDs allegedly were not backed by safe investments but rather were funded in typical Ponzi scheme fashion whereby Stanford used the new CD proceeds to make interest payments on existing CDs.

The defendant in the Chadbourne & Park case—the eventual petitioner in the case at bar—is a law firm that advised the Stanford entities. The plaintiffs are investors who were allegedly defrauded in Stanford's scheme. The defendant moved to dismiss the complaints under SLUSA, arguing that the court should adopt an expansive interpretation of "covered securities" to include the CDs even though the CDs themselves were not traded on a national exchange. The district court agreed and held that while the CDs themselves were not covered securities, dismissal was appropriate because the alleged fraudulent scheme coincided with, and depended upon, the sale of SLUSA covered securities for two reasons: (1) the CD purchases were induced by a belief that the CDs were backed in part by SLUSA covered securities; and, (2) more broadly, it was likely that at least one of the plaintiffs bought the Stanford CDs with proceeds of their IRA accounts, which contained covered securities.

The plaintiffs appealed to the U.S. Court of Appeals for the Fifth Circuit, which reversed, holding that the cases were not precluded because the "in connection with" requirement was not met. Adopting the Ninth Circuit view that the "in connection with" requirement must be satisfied by more than a tangential relationship and instead must be "the heart or the crux of the complaint," the Fifth Circuit held that the fraudulent scheme alleged was not more than tangentially related to the purchase or sale of covered securities and thus was not precluded by SLUSA.

The defendant filed a petition for writ of certiorari. In January 2013, the Supreme Court granted the defendant's petition, and consolidated the case with two related cases, which included as defendant-petitioners another law firm and insurance brokers that advised Stanford entities. The Supreme Court articulated the questions presented as follows: "(1) Whether the SLUSA precludes a state-law class action alleging a scheme of fraud that involves misrepresentations about transactions in SLUSA-covered securities; and (2) whether SLUSA precludes class actions asserting that defendants aided and abetted SLUSA-covered securities fraud when the defendants themselves did not make misrepresentations about the purchase or sale of SLUSA-covered securities."

"How broad is the word 'benefit'? Because that's really what this case comes down to."

- Justice Sotomayor

HIGHLIGHTS FROM ORAL ARGUMENT

Counsel for the petitioners argued that the CD transactions "clearly included material misrepresentations about transactions in covered securities" and argued that the case was precluded by SLUSA and thus should be dismissed.

Justice Kagan noted that in most securities fraud cases, the market for securities is affected, but in this case, there was "in fact, [no] affect [on] any securities trading. What it affect[ed] was a decision to . . . buy CDs."

Justice Scalia asked how the case fit within the purpose of the securities laws, and stated: "I had assumed that the purpose of the securities laws was to protect the purchasers and sellers of the covered securities. There is no purchaser . . . or seller of a covered security involved here."

Justice Kennedy asked counsel for petitioners how he would frame the proper test to determine whether SLUSA applies. Petitioners' counsel responded that "the simplest, narrowest way to decide this case is to say that when there is a misrepresentation and a false promise to purchase covered securities for the benefit of the plaintiffs, then the 'in connection with' standard is [satisfied]."

Counsel for the United States argued briefly in support of the petitioners' interpretation of SLUSA, arguing that "the issue in this case is that it involves a false promise to purchase covered securities using the fraud victims' money in a way that they are told is going to benefit them, and that that is a classic securities fraud."

Justice Sotomayor asked "how broad is the word 'benefit'? Because that's really what this case comes down to." Counsel for the United States responded that "benefit" should not be restricted to mean through ownership of the securities.

Justice Scalia suggested the statutory language was not satisfied as "there has been no purchase or sale here." Counsel for the United States responded that a "purported purchase" is sufficient to implicate SLUSA protection.

Justice Kagan framed the question of whether or not the fraud should be exclusively dealt with in the federal courts as follows: "Is this the kind of representation that could affect somebody? It doesn't have to be the victim of the fraud, it can be somebody else, but that could affect somebody's decision to buy or sell or hold covered securities. Can you satisfy that test?"

Counsel for plaintiff-respondents argued that his clients should be allowed to proceed with litigation because they brought state court actions that "Congress specifically excluded from preclusion under SLUSA." Counsel asked the Court to affirm the Fifth Circuit and adopt a rule "that a false promise to purchase securities for one's self in which no other person will have an interest is not a material misrepresentation in connection with the purchase or sale of covered securities."

Justice Kennedy asked what respondents' counsel's position is "if the broker says, 'Give me $100,000 and I will buy covered securities,' and then he just pockets it [and] flees?" Counsel responded "That is securities fraud, in our view, according to the SEC's administrative position. . . we still prevail because what's happening is the broker is saying: 'I will purchase for you the covered securities.'"

Justice Alito asked "whether there has to be an actual purchase or sale [of securities]?" Counsel for respondents responded that "it is not essential to our position," and "if you agree with the SEC that there doesn't have to be a purchase or sale, we still easily win the case."

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- Justice Kagan

IMPLICATIONS

In *Troice*, the Court has the opportunity to clarify the "in connection with" language of SLUSA to determine the breadth of the preclusive effect of the statute. If the Court agrees with plaintiff-respondents' position, the scope of SLUSA would be narrowed, potentially allowing more securities fraud class actions to proceed in state court. Should the Supreme Court adopt the broader tests of the Second, Sixth and Eleventh circuits, it would be a rare state-law class securities class action that would not be precluded by SLUSA and, as respondents' counsel suggested at oral argument, such an interpretation could be grounds for the SEC to expand the scope of securities fraud cases they pursue. The questioning by various Justices suggests that the Court may define a narrower interpretation of the "in connection" requirement, although the questions of respondents' counsel by Justices Kennedy and Alito suggest that the Court is not necessarily of one mind yet. Moreover, the questioning of the Justices regarding whether a purchase or sale of covered securities ever occurred also suggests that the Justices may defer determining the scope of SLUSA and remand to consider whether the transactions at issue involved securities covered by SLUSA.

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