OnPoint Dechert LLP

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A Legal Update from Dechert LLP

The United States Supreme Court Will Review the Scope of Federal Preclusion of State Securities Claims

On January 18, 2013, the United States Supreme Court granted certiorari to resolve a circuit split concerning the extent to which the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") preempts state law claims that indirectly arise out of securities claims. The case could have important implications for investor suits against hedge funds and other investment funds that are not themselves covered by SLUSA, but that are set up for the purpose of investing in equities, options, and other covered securities.[1]

The Supreme Court granted review in three consolidated cases that arose from the $7 billion dollar Ponzi scheme run by Allen Stanford and companies under his control. Stanford perpetrated the scheme by issuing certificates of deposit ("CDs") from Stanford International Bank that the bank falsely claimed were backed by safe, liquid investments. But the investments did not exist. The bank used proceeds from new CD sales for interest and redemption payments on previously issued CDs.

After the fraud was discovered, Stanford's investors sued the bank's insurance brokers and lawyers, as well as the Stanford group, claiming violations of Texas and Louisiana law. The investors alleged that the defendants falsely represented that the bank's assets backing the CDs were invested in a "well-diversified portfolio of highly marketable securities issued by stable national governments, strong multinational companies, and major international banks."

The cases were consolidated in federal district court in the North District of Texas. The district court dismissed the complaints pursuant to SLUSA, which precludes most state-law class actions alleging "a misrepresentation or omission" made "in connection with the purchase or sale of a covered security."[2] The plaintiffs argued that SLUSA did not apply because the relevant investments were the CDs, not the underlying covered securities. But the district court disagreed and held that SLUSA preemption sweeps more broadly. Adopting the test employed by the Eleventh Circuit, the district court held that plaintiffs' state law claims were preempted because they were based on "fraud that induced [the plaintiffs] to invest."[3]

The Fifth Circuit reversed. The Court recognized that the Courts of Appeals were divided over the standard for determining whether an alleged misrepresentation is "in connection with" the purchase or sale of a covered security. The Fifth Circuit explained that each Circuit that has addressed the issue has "adopted a slightly different articulation of the requisite connection between the fraud alleged and the purchase or sale of securities (or representations about the purchase or sale of securities)."[4]

The standards articulated by the Circuits essentially fall into two categories. The Second, Sixth, Seventh, Eighth, and Eleventh Circuits have interpreted the scope of SLUSA preclusion broadly. Those circuits hold that SLUSA precludes a state law claim when an alleged fraud "coincides with" or "depends upon" a transaction in securities covered by SLUSA.[5] By contrast, the Ninth Circuit, and now the Fifth Circuit, adopted a narrower interpretation, holding that SLUSA precludes a state law claim only if "there is a relationship in which the fraud and the stock sale coincide or are more than tangentially related."[6] The Fifth Circuit concluded that under this standard the plaintiffs' state law claims survived SLUSA preclusion.[7] The defendants in each of the cases petitioned the Supreme Court for certiorari.

In granting certiorari, the Supreme Court now will consider whether SLUSA precludes plaintiffs from bringing a class action for alleged violations of state law where the investments at issue are not covered securities

but the underlying allegations relate to or arise in connection with the purchase or sale of covered securities. If the Supreme Court affirms the Fifth Circuit's holding and reads "in connection with" narrowly, then plaintiffs may bring more state law claims against investment managers and other advisors to investment funds, and more of those claims may survive motions to dismiss.[8] In addition, a narrow interpretation of SLUSA could lead to more of those claims proceedings in state court. The ability to bring state law claims as well as potentially having a choice of forum may be perceived to provide plaintiffs with more leverage in litigating and/or settling the claims.

By contrast, if the Supreme Court reverses, defendants will have another powerful weapon to limit claims by disgruntled investors to only those that can meet the heightened pleading requirements for fraud claims under the Private Securities Litigation Reform Act of 1995, which would likely reduce the number of marginal claims brought against investment managers and other advisors.

The Supreme Court has not yet scheduled the argument date for the SLUSA cases. The cases are *Chadbourne & Parke LLP v. Troice*, U.S. Supreme Court. No. 12-79; *Willis of Colorado Inc. v. Troice*, U.S. Supreme Court, No. 12-86; and *Proskauer Rose LLP v. Troice*, U.S. Supreme Court, No. 12-88.

Footnotes

[1] A "covered security" refers to a security listed on a national exchange, which can include equities, options, bonds and other debt instruments. 15 U.S.C. § 78bb(f)(5)(E). Limited partnerships or similar products that are not traded on an exchange are not covered.

[2] 15 U.S.C. § 78bb(f)(1)(A). Although the CDs themselves are not "covered securities," the district court held that the plaintiffs allegedly made misrepresentations in connection with transactions for covered securities.

[3] *Instituto de Prevision Militar v. Merrill Lynch*, 546 F.3d 1340, 1349 (11th Cir. 2008).

[4] *Roland v. Green*, 675 F.3d 503, 520-21 (5th Cir. 2012).

[5] *See id.* (citing *Dabit. 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) (discussing that the fraud must involve covered securities, but noting that a simple "but for" relationship between an alleged fraud and the purchase or sale of securities is an insufficient test); *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*, 546 F.3d at 1349 (SLUSA precludes fraud claims when the fraud allegedly "induced [plaintiffs] to invest with [the defendant(s)]" or "a fraudulent scheme . . . coincided and depended upon the purchase or sale of [covered] securities").

[6] *Roland*, 675 F.3d at 520-21 (quoting *Madden v. Cowen & Co.*, 576 F.3d 957, 965-66 (9th Cir. 2009)) (emphasis omitted).

[7] The Fifth Circuit adopted that standard because SLUSA preclusion (a) "must not be construed so broadly as to [encompass] every common-law fraud that happens to involve [covered] securities," (b) the connection between the alleged fraud and the purchase or sale of securities "must be taken seriously," and (c) the "legislative intent . . . militate[s] against an overbroad formulation." *Roland*, 675 F.3d at 520 (citations omitted).

[8] The Supreme Court did not grant review of the other issue presented in the petitions for certiorari – whether SLUSA precludes claims against alleged aiders and abettors of SLUSA-covered securities fraud who themselves have made no misrepresentations concerning covered-security transactions, or whether such claims may proceed as state-law class actions.

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