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An Underused Defense to State Law Class Actions

SLUSA Remains Viable Even After *Chadbourne & Park v. Troice*

By Bailey King

and Tim Lendino

In the right cases, defense lawyers can successfully dismiss class claims under SLUSA at early stages, saving clients the significant expenses associated with class actions.

The Securities Litigation Uniform Standards Act of 1998 (SLUSA) provides a strong but underused defense to securities class actions brought under state laws. Generally speaking, SLUSA bars plaintiffs from bringing state law class claims arising from misrepresentations made in connection with the sale or purchase of securities. Given this standard, defense lawyers understandably may hesitate to raise this defense because prevailing on such a defense would likely invite a federal securities class action. Federal securities law, however, is often more advantageous to defendants than common law claims arising under state law. Thus, as discussed below, in most cases, this reluctance is unwarranted.

Last year, the Supreme Court held, in *Chadbourne & Parke, LLC v. Troice*, that SLUSA did not preclude plaintiffs' state law class action claims arising from the Stanford Ponzi scheme because the claims did not involve covered securities. Legal commentators were quick to conclude that SLUSA would be more narrowly construed by the courts after *Chadbourne*. To the contrary, however, SLUSA is still a far-reaching statute. Indeed, several recent decisions from the Second Circuit demonstrate this point.

This article discusses what SLUSA does, how the Supreme Court construed SLUSA in *Chadbourne*, and why SLUSA continues to provide a powerful defense in a broad spectrum of cases involving investment products. Defense litigators should familiarize themselves with SLUSA and carefully consider its application when initially assessing defenses to a class action. By successfully dismissing class claims under SLUSA at an early dispositive stage, defense lawyers can save their clients the significant expenses associated with defending a class action.

Overview of SLUSA

Congress passed SLUSA in 1998 because it found that plaintiffs were bringing securities class actions under state laws to avoid the requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA), which, among other things, imposed heightened pleading requirements and limited the amount of recoverable damages in federal securities class actions. *See Mer-*

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rill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 81–82 (2006). *See also* H.R. Rep. No. 105-640, p. 10 (1998). Perhaps most frustrating to plaintiffs, the PSLRA provides an automatic stay of discovery during the pendency of a motion to dismiss. 15 U.S.C. §77z-1(b).

Fraud claims are typically brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5, generated by the U.S. Securities and Exchange Commission (SEC), and therefore, they are filed in federal courts and subject to the PSLRA. In light of the burdens established by the PSLRA, plaintiffs had attempted to circumvent the PSLRA procedural hurdles by filing class actions in state court. Filing in state court also avoided consolidation with any pending or later-filed federal actions, which could have important consequences on how attorneys' fees are allocated if a case led to a settlement.

In response, Congress enacted SLUSA to preclude state law class actions involving securities, which were evading the PSLRA's restrictions. SLUSA did two things. First, SLUSA required that securities class actions be filed in federal court. 15 U.S.C. §77p(c). Second, SLUSA required that securities class actions be filed under federal law. *Id.* In other words, SLUSA requires federal courts to dismiss class actions involving securities based on state law. *See Herndon v. Equitable Variable Life Ins. Co.*, 325 F.3d 1252, 1253 (11th Cir. 2003).

In particular, SLUSA precludes any "covered class action" based on state law that alleges a misrepresentation or omission of material fact "in connection with" the purchase or sale of a "covered security." 15 U.S.C. §77p(b); *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1059 (2014). Instead, a plaintiff must either (1) pursue their state law claims individually, or (2) abandon their state law claims and bring a federal securities law class action. SLUSA defines "covered security" to include securities traded on a national exchange or securities issued by investment companies (*i.e.*, annuities, variable life insurance policies, and similar investment products).

Under SLUSA, a "covered class action" includes

> any single lawsuit in which... damages are sought on behalf of 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members.

15 U.S.C. §77p(f)(2)(A).

The reach of SLUSA preclusion has been broad, that is, the so-called "in connection with" requirement has historically been interpreted broadly. Indeed, state law claims based on alleged misrepresentations in complex commercial transactions, such as alleged tax shelter schemes, were precluded by SLUSA when only parts of the transaction involved covered securities. *See Stechler v. Sidley, Austin Brown & Wood, L.L.P.*, 382 F. Supp. 2d 580, 597 (S.D.N.Y. 2005) (holding that the "in connection with" requirement was satisfied where securities transactions were a "key part" of the tax avoidance strategy). As such, SLUSA has the potential to apply to a wide variety of commercial transactions, depending on the interpretation of the "in connection with" requirement.

The "In Connection With" Tension

Before the Supreme Court decision in *Chadbourne & Park v. Troice* last year, the federal circuit courts had been split in their interpretation of the "in connection with" requirement. This split developed after the United States Supreme Court decision in *Dabit*, which adopted a "broad interpretation" of the "in connection with requirement" under which "it is enough that the fraud alleged *coincide* with a securities transaction." *Dabit*, 547 U.S. at 85 (emphasis added). In *Dabit*, the Supreme Court reasoned that by "import[ing] the key phrase—'in connection with the purchase or sale'—into SLUSA's core provision," Congress intended SLUSA to have the same "*broad construction* adopted by both this Court and the SEC" in interpreting the identical words that appear in §10(b) of the Securities Exchange Act of 1934. *Id.* (emphasis added). Indeed, the "in connection with" language under SLUSA "has the same meaning as the same words used in §10(b) of the Exchange Act and Rule 10b-5." *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 310 (6th Cir. 2009) (citing *Dabit*, 547 U.S. at 85–86)).

Accordingly, the Supreme Court held that a misrepresentation that merely "coincide[s]" with the purchase or sale of a security is "enough" to satisfy the "in connection with requirement." *Dabit*, 547 U.S. at 85. Under this broad interpretation, "[m]isrepresentations that induce an investment of funds to the investor's detriment are often sufficient to meet the 'in connection with' requirement." *Levinson v. PSCC Servs., Inc.*, No. 3:09-cv-00269, 2009 WL 5184363, at *9 (D. Conn. Dec. 23, 2009) (finding that the alleged misrepresentations "are not required to contain specific securities information or investment advice in order to coincide with the securities transactions.").

In light of the burdens established by the PSLRA, plaintiffs had attempted to circumvent the PSLRA procedural hurdles by filing class actions in state court.

Following *Dabit*'s liberal construction of the "in connection with" requirement, the circuit courts developed varying tests in deciding what types of cases ought to be precluded by SLUSA. *C.f. Roland v. Green*, 675 F.3d 503 (5th Cir. 2012) (adopting more narrow interpretation of "in connection with" requirement to hold that the misrepresentation must be "more than tangentially related" to the sale or purchase of a security). Ultimately, this heavily litigated question made its way back to the Supreme Court (again) in the *Chadbourne* case.

Chadbourne & Park v. Troice and the Result

In February 2014, the Supreme Court reaffirmed its "broad interpretation" of the "in connection with requirement" and provided a framework for analyzing whether a misrepresentation meets this requirement in *Chadbourne & Park LLC v. Troice*, 134 S. Ct. 1058 (2014). *Chadbourne* arose from the Ponzi scheme masterminded by Allen Stanford. One of Stanford's corporate entities, Stanford International Bank (SIB), sold the plaintiffs certificates of deposit, which SIB promised were backed by a portfolio of assets that included SLUSA-covered securities. Plaintiffs filed class actions under state law alleging that various professional firms made material misrepresentations and omissions of fact, and aided and abetted Stanford's scheme. Each suit alleged that the fraud included misrepresentations concerning SIB's investments in SLUSA-covered securities.

Thus, attorneys that defend against federal securities fraud claims often find themselves arguing that certain misrepresentations were not made "in connection with" the sale or purchase of a security for purposes of SEC Rule 10b-5 claims. This is exactly the opposite of the argument to make when seeking to dismiss a state law class action under SLUSA.

In *Chadbourne*, the CDs purchased by the plaintiffs were *not* covered securities. *Id.* at 1071. The plaintiffs alleged, however, that the defendants misrepresented that the CDs would be invested in "safe" investments, including shares of stock on a national exchange (*i.e.*, "covered securities"). *Id.* In fact, the defendants were operating a Ponzi scheme, and the CDs were never invested in "covered securities." *Id.* at 1064–65. Consequently, the Supreme Court held that the "in connection with" requirement had not been satisfied. *Id.* at 1071. In doing so, the Supreme Court recognized that "a fraudulent misrepresentation or omission is not made 'in connection with' such a 'purchase or sale of a covered security' unless it is material to a decision by one or more individuals (other than the fraudster) to buy or sell a 'covered security.'" *Id.* at 1066.

Importantly, in *Chadbourne*, the alleged misrepresentations were not designed to induce anyone to purchase "covered securities." Instead, it was undisputed that the alleged misrepresentations were made to induce the purchase of "uncovered securities," that is, the CDs. *Id.* at 1065. Indeed, the *Chadbourne* plaintiffs were not seeking, directly or indirectly, to purchase covered securities at any point in time.

Many commentators have concluded that *Chadbourne* limited SLUSA's reach. *See* Daniel Dietrich, *The Limits of SLUSA Preemption*, JD *Supra* Business Advisor (Apr. 29, 2014), http://www.jdsupra.com/legalnews/the-limits-of-slusa-preemption-92849/ (last visited May 8, 2015); Jennifer Lee *et al.*, *Supreme Court Narrows the Scope of SLUSA Preemption, Green-Lighting State Law Class Action Claims Alleging Ponzi Scheme*, Orrick: Securities Litigation, Investigations and Enforcement (Mar. 4, 2014), http://blogs.orrick.com/securities-litigation/tag/slusa/ (last visited May 8, 2015); Jay Shapiro, *Chadbourne & Parke v. Troice: Will the Supreme Court's Narrow Statutory Interpretation Open A Wide Door to Securities Lawsuits?*, 20 Westlaw Journal Derivatives 1 (2014). Some may even argue that *Chadbourne* opens up a new avenue for plaintiffs to bring class actions in state court that touch as securities fraud but do not involve a situation in which a plaintiff directly purchased a covered security. In actuality, the Supreme Court decision in *Chadbourne* should not be surprising. Indeed, the fraudulent scheme at issue in that case was so tangential to the purchase of a covered security that the plain language of SLUSA easily dictated that the statute should not preclude such claims.

SLUSA Continues to Be a Powerful Defense

To some extent, defense attorneys have been conditioned to think that the "in connection with" requirement should be interpreted narrowly. This is because the "in connection with" language under SLUSA has the same meaning as the same words used in §10(b) of the Securities Exchange Act and SEC Rule 10b-5. Thus, attorneys that defend against federal securities fraud claims often find themselves arguing that certain misrepresentations were not made "in connection with" the sale or purchase of a security for purposes of SEC Rule 10b-5 claims. This is exactly the opposite of the argument to make when seeking to dismiss a state law class action under SLUSA. Moreover, defense attorneys may even be cautious in arguing for a broad interpretation of the "in connection with" requirement under SLUSA because this may invite possible federal securities fraud claims under §10(b) of the Securities Exchange Act and SEC Rule 10b-5. Although this may sound troublesome at first blush, this is actually preferable from a defense standpoint because of the PLRSA procedural hurdles to federal claims, compared to state law claims.

Defense attorneys may find it advantageous to find ways to navigate their cases into the securities law arena because of the protections of SLUSA and the PLRSA. This is a good strategy, and it is important for defense attorneys to consider carefully whether the claims at issue in their cases arguably involve misrepresentations or omissions related to securities. Opportunities to steer a case into the realm of securities law may be more accessible than someone may think. Indeed, certain cases that do not appear to be securities fraud cases may nonetheless fall within the scope of SLUSA. For example, misrepresentations related to retirement planning, such as deferred compensation and insurance products, may relate to "securities" within the meaning of SLUSA. *See Demings v. Nationwide Life Insurance Co.*, 593 F.3d 486 (6th Cir. 2010) (affirming dismissal of claims involving material omissions made in connection with payments under deferred compensation plans).

After *Chadbourne*, several courts have continued to preclude lawsuits based on SLUSA, even in the face of plaintiffs' arguments that *Chadbourne* dictated a narrow application of the "in connection with" requirement. For example, the Second Circuit recently affirmed a SLUSA-based dismissal of a lawsuit arising out of Bernie

Madoff's legendary fraud, which alleged that misrepresentations were made in the purchase of uncovered shares in offshore funds based on the understanding that the funds would invest in covered S&P 100 stocks. *In re Kingate Mgmt. Ltd. Litig.*, No. 11-1397-CV, 2015 WL 1839874, at *10 (2d Cir. Apr. 23, 2015). *See also In re Herald*, 753 F.3d 110 (2d Cir. 2014). Of course, S&P 100 stocks are covered securities under SLUSA, but the plaintiffs argued that they never directly purchased covered securities. Thus, these plaintiffs claimed that they were similar to the *Chadbourne* plaintiffs, who only purchased uncovered CDs. The Second Circuit distinguished *Chadbourne* on the grounds that the *Chadbourne* plaintiffs "were not seeking, directly or indirectly, to purchase covered securities." *Kingate*, 2015 WL 1839874, at *9. To the contrary, the plaintiffs in *Kingate* and *Herald* were "indirectly purchasing an interest in the covered S&P securities" and "attempt[ing] investments in covered securities, albeit through feeder funds." *Id.*; *Herald*, 753 F.3d at 113.

As such, the *Kingate* and *Herald* cases illustrate that even in situations in which the plaintiffs only purchased an uncovered security, defendants may nonetheless be successful in arguing SLUSA preclusion. If the plaintiffs entered the transactions understanding or intending to purchase covered securities indirectly through a feeder fund, then SLUSA arguably applies. Indeed, the *Kingate* and *Herald* cases focus on the direct intention of a plaintiff investor to benefit from the indirect purchase of covered securities, and therefore SLUSA preclusion applies. Thus, defense attorneys should consider carefully the applicability of SLUSA as a defense in these types of "feeder fund" cases, and they should not summarily construe *Chadbourne* as limiting the applicability of SLUSA in cases when the plaintiffs did not directly purchase covered securities.

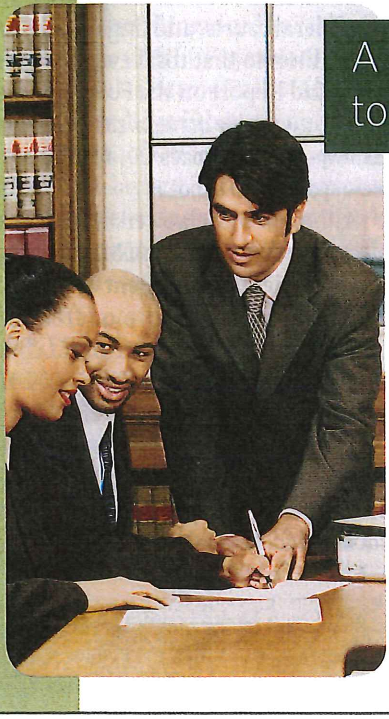
In addition, defense attorneys should consider that SLUSA may even preclude claims that are not pleaded as fraud or misrepresentation claims. Plaintiffs' attorneys have attempted to avoid SLUSA preclusion by artfully characterizing a claim of falsity as a breach of contract claim. Courts have consistently held that SLUSA cannot be circumvented by artful pleading that eliminates the covered words and ignores the realities underlying the claims. *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 311 (6th Cir. 2009) (holding that SLUSA precluded breach of contract claims that were truly based on a misrepresentation theory of liability). Similarly, courts have held that plaintiffs cannot avoid SLUSA by consciously omitting references to securities in their complaints. *In re Herald*, 730 F.3d 112, 118 (2d Cir. 2013).

The Future of SLUSA and What Litigators Need to Know

Defense litigators serving clients facing class actions should familiarize themselves with SLUSA and its reach. This is an underused tool that can have a dramatic and powerful bearing on successfully defending against class actions involving commercial transactions. Indeed, the First Circuit recently described SLUSA as "strong medicine" and "a spare but sweeping statute." *Hidalgo-Velez v. San Juan Asset Mgmt., Inc.*, 758 F.3d 98, 108 (1st Cir. 2014).

Despite *Chadbourne* and recent legal commentary pronouncing that SLUSA will be more narrowly construed by courts in the future, the reach of SLUSA remains remarkably broad. The Second Circuit recent decisions in *Herald* and *Kingate* show that SLUSA preclusion continues to be a prevailing argument even in cases in which plaintiff investors only *indirectly* purchase covered securities. If an investment product at issue in a case is marketed primarily as a vehicle for exposure to covered securities, then SLUSA preclusion still applies. As such, the preclusive effect of SLUSA continues to reach a broad spectrum of cases involving investment products.

Therefore, when initially assessing defenses to a class action, litigators should consider the potential applicability of SLUSA. In cases involving state law claims and an investment product of some type, litigators should carefully assess whether SLUSA might provide an avenue to dismiss the class claims. Litigators may be surprised to discover that SLUSA applies to certain commercial cases. By successfully dismissing class claims under SLUSA at an early dispositive stage, defense lawyers can save their clients the significant expense associated with defending a class action. FD



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