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Commentary
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THE 'IN CONNECTION WITH' REQUIREMENT AFTER *CHADBOURNE & PARK V. TROICE*

C. **Bailey King Jr**. and Timothy Lendino of Smith Moore Leatherwood discuss the recent court interpretations of "in connection with the purchase or sale of a covered security" following the U.S. Supreme Court's decision in Chadbourne & Park v. Troice.

The question of whether a misrepresentation is made "in connection with" the sale or purchase of a security is one of the most heavily litigated securities issues.

Historically, guidance from the courts on this issue has done nothing more than provide difficult-to-apply synonyms such as "coincide with" or "more than tangentially related."

Adding to the confusion, plaintiffs and defendants take different positions on the issue depending on the type of case.

In a case under Section 10-b(5) of the Securities Exchange Act, the "in connection with" requirement is an element of the plaintiff's claim. As a result, plaintiffs argue for a broad interpretation while defendants argue for a narrow one.

In securities class actions, however, the Securities Litigation Uniform Standards Act preempts state law claims that allege a misrepresentation "in connection with" the purchase or sale of a covered security.

In those cases, plaintiffs argue for a narrow interpretation of the requirement in an attempt to save their state-law class-action claims.

The result is a glut of case law that can be difficult to reconcile.

Last year, the U.S. Supreme Court once again weighed in on this issue in *Chadbourne & Parke LLC v. Troice*, 134 S. Ct. 1058 (2014), providing further guidance on how the "in connection with" requirement should be applied.

Observers followed the case closely to see whether the high court would narrow its interpretation of the requirement.

Though courts have had more than a year to interpret *Chadbourne*, it appears that the "in connection with" requirement has not changed.

Instead, the lasting impact of *Chadbourne* will more likely be its provision of an analytical framework that allows lawyers to reconcile the case law on this issue and determine whether a misrepresentation is made "in connection with" the purchase or sale of a security.

Tension with the 'in connection with' requirement

Before the Supreme Court's decision in *Chadbourne*, the federal circuit courts were split as to the proper interpretation of the "in connection with" requirement.

This split developed after the high court's holding in *Merrill Lynch v. Dabit.* [1]

In *Dabit*, the court adopted a "broad interpretation" of the "in connection with" requirement under which it was "enough that the fraud alleged *coincide[d]* with a securities transaction" (emphasis added).

***2** Following *Dabit*'s liberal construction of the requirement, the circuit courts developed varying tests to determine what types of connections were sufficient to meet it. [2]

But the guidance provided little more than conclusory labels, offering up terms such as "in connection with," "coincide," "more than tangentially related," and a misrepresentation that "matters."

Regardless of the label, it was clear that under *Dabit*'s broad interpretation, "[m]isrepresentations that induce an investment of funds to the investor's detriment [were] often sufficient to meet the 'in connection with' requirement." [3]

This heavily litigated question made its way back to the Supreme Court in the *Chadbourne* case.

Chadbourne *and its impact*

In February 2014 the Supreme Court used *Chadbourne* to reaffirm its "broad interpretation" of the "in connection with" requirement.

But it again failed to provide any bright-line rules or analytical framework for determining whether a misrepresentation meets the requirement.

Chadbourne arose from a Ponzi scheme masterminded by Allen Stanford.

One of Stanford's corporate entities, Stanford International Bank, sold certificates of deposit. SIB promised that the CDs were backed by a portfolio of assets that included covered securities.

SIB CD holders filed class actions under state law, alleging that various professional firms made material misrepresentations and omissions of fact. They further claimed that the defendants aided and abetted Stanford's scheme after the Ponzi scheme was discovered.

Each suit alleged the fraud included misrepresentations concerning SIB's investments in SLUSA-covered securities.

Importantly, the CDs purchased by the plaintiffs in *Chadbourne* were *not* covered securities.

The plaintiffs argued, however, that the defendants represented that the CDs would be invested in "safe" investments -- including shares of stock on a national exchange, which would be "covered securities."

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In fact, the defendants operated a Ponzi scheme, and the company never backed the CDs with "covered securities."

Consequently, the Supreme Court held that the "in connection with" requirement was unsatisfied.

The high court said 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.'"

Because the alleged misrepresentations were not designed to induce anyone to purchase "covered securities," the court found that the misrepresentations were not in connection with the sale or purchase of a covered security.

By relying on this fact, the court avoided a need to explain what "in connection with" means.

Nonetheless, many commentators concluded that *Chadbourne* limited SLUSA's reach. [4]

***3** The Supreme Court's decision in *Chadbourne* should not be surprising. Indeed, the fraudulent scheme at issue was entirely unrelated to the purchase of a covered security. As a result, the plain language of SLUSA dictated the conclusion that the "in connection with" requirement was not met.

In the year and a half since the *Chadbourne* decision, it appears the standard for meeting the "in connection with" requirement may not have changed at all.

What is clear from the post-*Chadbourne* cases is that inducement seems to be the lynchpin in the analysis -- this is, there must be a *misrepresentation* that *induces the purchase* of a *covered security* in connection with the sale of the covered security.

In other words, "inducement" appears to be the way to "connect" a misrepresentation to a covered security.

For this to work, there must be a misrepresentation and a covered security. If both elements are not present, the "in connection with" requirement is likely not satisfied.

Recent applications of Chadbourne

Chadbourne's impact is seen most clearly in cases where lower courts addressed the issue both before and after the high court's ruling was delivered, such as by a motion for reconsideration, a subsequent appeal or in response to an amended complaint.

In the cases below, the analysis and result were the same before and after the *Chadbourne* decision. Their takeaway is the analytical framework that has been fleshed out by *Chadbourne*.

In re Harbinger Capital

In re Harbinger Capital Partners Funds Investors Litigation, No. 12-cv-1244, 2015 WL 1439520 (S.D.N.Y. Mar. 30, 2015), involved a proposed class action arising from the plaintiffs' investments in a family of hedge funds managed by Harbinger Capital Partners LLC.

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The hedge funds were not covered securities. The plaintiffs alleged, however, that the defendants misrepresented that the types of investments made in the hedge funds were "marketed to be diversified, distressed-debt hedge funds."

In fact, the hedge funds purchased equity stakes in a public company named SkyTerra, which were covered securities.

Ultimately, Harbinger purchased the entire company, changed its name to LightSquared and went private.

Once LightSquared became a private company, Harbinger's interest was no longer a covered security because it no longer traded on a public exchange.

U.S. District Judge Alison J. Nathan of the Southern District of New York dismissed the plaintiffs' fourth amended complaint under SLUSA. Judge Nathan said the complaint asserted state law class-action claims based on alleged misrepresentations made in connection with the purchase of a security -- i.e., the purchase of equity securities in SkyTerra. [5]

The Supreme Court issued the *Chadbourne* opinion thereafter. The plaintiffs then filed a sixth amended complaint, attempting to replead their state law class-action claims.

***4** In their sixth amended complaint, the plaintiffs attempted to limit their claims to misrepresentations made after LightSquared went private because it was no longer a covered security at that time.

The plaintiffs said that had these misrepresentations and omissions not been made, they would have divested themselves of their interest in the hedge funds.

In considering Harbinger's renewed motion to dismiss, Judge Nathan reasoned that the critical issue was whether the plaintiffs' "allegations involving LightSquared are unrelated to [Harbinger's] acquisition of covered SkyTerra securities in a meaningful way, or just a superficial one."

Judge Nathan recognized this "temporal question" went unaddressed in *Chadbourne*. However, she further noted that *Chadbourne* "did set forth principles that guide [the] inquiry."

She stated that *Chadbourne* "did not disturb the Supreme Court's prior holding in *Dabit*, which read SLUSA broadly to hold that preclusion does not depend on the plaintiffs being the direct purchasers of the covered security, or the plaintiffs and the defendant being in a buyer-seller relationship."

Rather, Judge Nathan determined that "the 'in connection with' requirement can fairly be said to have both a narrow and broad dimension."

First, "[i]t is narrow insofar as allegedly fraudulent statements must be of the type that would induce someone to buy or sell (or hold) a covered security."

Once this is established, however, "the scope of what is precluded is broad."

With this in mind, Judge Nathan held the plaintiffs had "plead[ed] a single fraud that caused them to purchase or hold their investments -- a fraud that began with material misstatements and omissions made in connection with the purchase of a covered security, SkyTerra, and continued with the same misrepresentations and omissions after SkyTerra became the privately held company LightSquared."

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Accordingly, Judge Nathan reasoned that "[t]o carefully excise the allegations involving purchase and holding of interests in the [hedge funds] during the acquisition of SkyTerra [was] artful pleading" and that the claims were based on misrepresentations made "in connection with" the purchase of a covered security, just as she had determined before *Chadbourne*.

In re Herald

In *In re Herald*, 753 F.3d 110 (2d Cir. 2014), investors sued several banks for their alleged involvement in the Bernie Madoff scandal.

The plaintiffs alleged Bernard L. Madoff Investment Securities induced them to invest with the company by misrepresenting that their money would be invested in covered securities.

In fact, Madoff Securities operated a Ponzi scheme and never invested the plaintiffs' money in those securities.

Before the Supreme Court issued *Chadbourne*, the 2nd U.S. Circuit Court of Appeals affirmed the dismissal of the state law class-action claims under SLUSA on the grounds that plaintiffs had alleged a misrepresentation "in connection with" the purchase of a covered security -- even though no covered securities were ever purchased. [6]

***5** The plaintiffs then filed a petition for rehearing in light of the Supreme Court's decision to hear the *Chadbourne* case.

After the high court issued *Chadbourne*, the 2nd Circuit denied the petition for rehearing, finding that *Chadbourne* did not alter its analysis.

In reaching this result, the appellate panel rejected the plaintiffs' argument that their case was similar to *Chadbourne* because in both cases no covered securities were purchased. The panel reasoned that the plaintiffs in *Chadbourne* did not attempt to purchase covered securities.

Thus, the panel concluded, "a plaintiff in [*Chadbourne*] was entirely distinguishable from a 'victim who took, *tried to take*, or maintained an ownership position in [a covered security].'"

In contrast, "Madoff Securities ... fraudulently induced attempted investments in covered securities, albeit through feeder funds ... and the defendant banks [were] alleged to have furthered that scheme."

The 2nd Circuit found that the fact that Madoff Securities "fraudulently failed to follow through on its promise to place the investments in covered securities does not in any respect remove this case from the ambit of SLUSA as defined in [*Chadbourne*]."

In short, *Chadbourne* not only failed to change the 2nd Circuit's analysis; indeed, the panel found that it actually "confirm[ed] its logic."

The panel said that when a misrepresentation is made for the purpose of inducing the purchase of a covered security, the "in connection with" requirement is met regardless of whether the purchase is ultimately effectuated.

In re Kingate Management

In re Kingate Management Ltd. Litigation, 784 F.3d 128 (2d Cir. 2015), also involved a class action arising from Madoff's legendary fraud.

In this case, the misrepresentations were allegedly made in the purchase of uncovered shares in offshore funds on the understanding that the funds would be invested in covered S&P 100 stocks.

Shareholders sued individuals and entities affiliated with Kingate Global Fund Ltd. and/or Kingate Euro Fund Ltd., which were feeder funds that suffered investment losses in Madoff's Ponzi scheme.

The plaintiff class alleged Kingate was obligated to manage the investment of funds in S&P 100 companies' common stock.

Instead, Kingate gave management authority to Madoff, who purported to purchase and sell S&P 100 securities but did not in fact do so.

The plaintiffs' complaint asserted 28 state law claims, alleging misrepresentations and breaches of other legal and contractual obligations.

Essentially, the plaintiffs premised their legal theories on Kingate's failure to satisfy its obligations to evaluate and monitor the investment of their assets.

Kingate moved to dismiss the complaint, arguing SLUSA precluded the claims because they arose out of misrepresentations made "in connection with" the sale or purchase of covered securities.

***6** Before *Chadbourne* was decided, the District Court dismissed the complaint, holding that the SLUSA barred the claims. [7]

During the pendency of the appeal to the 2nd Circuit and after oral argument, the *Chadbourne* decision was published.

The 2nd Circuit disagreed with the District Court as to the dismissal of certain claims and vacated the district court's judgment.

The panel also affirmed the dismissal of the plaintiffs' other claims in accordance with SLUSA.

The 2nd Circuit grouped the various claims together and analyzed each grouping separately to assess whether they were precluded by SLUSA.

Some claims involved allegations of fraudulent misrepresentations made directly by Kingate, while others involved allegations of fraudulent misrepresentations made by only Madoff.

As one should have expected, the panel held that SLUSA precluded the claims in which Kingate allegedly made direct misrepresentations.

The appellate court followed *In re Herald*'s interpretation of *Chadbourne* and its "in connection with" requirement.

More noteworthy was the 2nd Circuit's decision to analyze the group of claims based not on the alleged misrepresentations of Kingate but instead on Kingate's failure to detect Madoff's fraud.

The panel concluded that SLUSA did not preclude that group of claims because the allegations with respect to them were not based on misrepresentations but on negligent management by a third party.

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Moreover, the 2nd Circuit noted that such allegations "differ[ed] crucially from those found in *Herald* to be precluded by SLUSA" because "[t]he *Herald* claims asserted liability based on defendants' alleged complicity in Madoff's fraudulent scheme."

Thus, *Kingate* holds that for SLUSA preclusion to apply, a claim must contain not only allegations involving material misstatements in connection with the purchase or sale of a covered security but also allegations about a defendant's own direct activity.

"Only conduct by the defendant is sufficient to preclude an otherwise covered class action," the decision says.

In other words, there must be a misrepresentation either made or aided and abetted by the defendant.

Otherwise, there is no connection between the misrepresentation by some third party and the plaintiff's decision to purchase or sell the covered security.

At that point, they are too "tangentially related."

Conclusion

It has long been exceedingly difficult for courts to agree on a test that determines when the "in connection with" requirement is satisfied. Unfortunately, the Supreme Court did not provide one in *Chadbourne*.

However, *Chadbourne*'s logic does allow one to decipher what the phrase means and develop a cogent argument for what does and does not satisfy the "in connection with" requirement.

Put simply, the requirement means there must be something connecting an alleged misrepresentation to a covered security.

*7 This cause-and-effect relationship is most clearly shown when an alleged misrepresentation induces a decision by the plaintiff to purchase or sell a covered security.

If not, the alleged misrepresentation is probably too "tangentially related," does not "matter" or "coincide" with, and is not "in connection with" the sale or purchase of a security.

Footnotes

1 547 U.S. 71 (2006).

2 *Cf. 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).

3 *Levinson v. PSCC Servs.*, 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.")

4 *See* Daniel Dietrich, *The Limits of SLUSA Preemption*, JD Supra Business Advisor: Securities Litigation (Apr. 29, 2014), http:// www.jdsupra.com/legalnews/the-limits-of-slusa-preemption-92849/; 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/2014/03/04/supreme-court-narrows-the-scope-of-slusa-preemption-green-

lighting-state-law-class-action-claims-alleging-ponzi-scheme/; Jay Shapiro, *Chadbourne & Parke v. Troice: Will the Supreme Court's Narrow Statutory Interpretation Open A Wide Door to Securities Lawsuits?*, 20 Westlaw J. Derivatives 1 (2014).

5 *In re Harbinger Capital Partners Funds Investors Litig.*, No. 12-cv-1244, 2013 WL 5441754 (S.D.N.Y. Sept. 30, 2013).

6 *In re Herald*, 730 F.3d 112 (2d Cir. 2013).

7 *In re Kingate Mgmt. Ltd. Litig.*, No. 09-CV-5386, 2011 WL 1362106 (S.D.N.Y. Mar. 30, 2011).

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