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Securities

Class Actions

The U.S. Supreme Court should have decided *Chadbourne & Parke LLP v. Troice* narrowly on the facts before it, which included a Ponzi scheme, Skadden Arps attorneys Amy S. Park and Aaron T. Morris say. By not doing so, the court narrowed the reach of federal securities law and strengthened the ability of investors to pursue securities fraud claims under state law, they say. The court's holding ''contravenes the fair expectations of market participants and their advisors, as well as Congress's goal of maintaining uniformity in litigation involving the purchase and sale of covered securities,'' they add.

The Supreme Court Missed an Opportunity in *Chadbourne* to Maintain Uniformity Within Class Action Securities Litigation Involving Nationally-Traded Securities

BY AMY S. PARK AND AARON T. MORRIS

The Supreme Court's decision in *Chadbourne & Parke LLP v. Troice* narrows the reach of the federal securities laws and strengthens the ability of investors to pursue securities fraud claims under state law. The result, however, creates an unnecessary gap in the federal regulatory scheme fashioned by Congress to uniformly apply to litigation involving nationally-traded securities. That uniformity was intended to provide certainty to market participants and promote efficiency in the capital markets. The Court missed an opportunity to narrowly decide *Chadboune* on the unique facts presented, and by so doing, preserve the fair expectations of market participants and their advisors.

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A Brief Orientation on the PSLRA, SLUSA, and the 'In Connection With' Requirement.

The Private Securities Litigation Reform Act (''PSLRA'') was enacted in the mid-1990s at a time when class action securities litigation had become unwieldy.[1] Plaintiffs' attorneys scoured the markets for any hint of impropriety through which a securities class action could take life. With such suits came oppressive discovery and negative press, imposing great cost on market participants and their advisors.

[1] *See Roland v. Green*, 675 F.3d 503, 507 (5th Cir. 2012).

In 1995, Congress passed the PSLRA to curb some of the abuses.[2] Although successful for their intended purpose, the reforms had the unintended effect of encouraging plaintiffs' attorneys to file securities class actions in state courts under state law (a strategy rarely encountered before the PSLRA).[3] To close this end-run around the PSLRA, Congress passed the Securities Litigation Uniform Standards Act (''SLUSA''), which barred certain state law class actions alleging misrepresentations ''in connection with the purchase or sale'' of nationally traded securities or securities issued by a registered investment company (collectively referred to by SLUSA as ''covered securities'').[4] SLUSA was enacted to ensure that a uniform federal regulatory scheme governed securities class actions alleging fraud ''in connection with'' the purchase or sale of covered securities. But the drafters were silent as to the meaning of ''in connection with,'' leaving courts to determine exactly how ''connected'' a fraud must be to fall within SLUSA's reach.

The Supreme Court first provided guidance in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, holding that the Court's decisions broadly interpreting ''in connection with'' in the context of Section 10(b) apply equally to SLUSA.[5] Relying on those cases, the Court determined that SLUSA applies to preclude state law claims so long as ''the fraud alleged coincide[s] with a securities transaction—whether by the plaintiff or by someone else.''[6] Applying that standard to the case before it, the Court in *Dabit* held that SLUSA precluded state law claims brought by investors alleging that they were tricked into holding their shares, rather than purchasing or selling any securities.[7]

Justice Stevens, writing for a unanimous Court, noted that in the context of ''holder'' claims, the ''special risk of vexatious litigation'' created a particular need to include such claims within the federal scheme. Moreover, because holder claims are not much different from traditional securities fraud claims—the kind that federal law has ''long been the principal vehicle for asserting''—the Court saw no reason to carve those claims out of the federal scheme. The Court reasoned that a holder claim is ''distinguishable from a typical 10b-5 class action in only one respect: It is brought by holders instead of purchasers or sellers. For purposes of SLUSA pre-emption, that distinction is irrelevant.''[8]

Thus, *Dabit* appeared to suggest that at least two important considerations should guide courts in determining SLUSA's reach: (1) whether the securities fraud claims at issue are of the type of litigation traditionally asserted under federal law; and (2) the potential detriment to market participants if the claims were to be adjudicated under state law.

Chadbourne Involves Securities Fraud Claims Brought by Investors in a Ponzi Scheme Against Secondary Actors.

In *Chadbourne*, the plaintiffs were investors in certificates of deposits (''CDs'') issued by Allen Stanford and his Antiguan bank, Stanford International. Stanford told investors that the CDs offered above-market returns and were backed by ''a well-diversified portfolio of highly marketable securities issued by stable governments, strong multinational companies and major international banks.''[9] In reality, the CDs were not backed by much of anything. Stanford misappropriated most of the bank's assets to ''repay old investors, to finance an elaborate lifestyle, and to finance speculative real estate ventures.''[10]

In four actions consolidated in the U.S. District Court for the Northern District of Texas, investors in the scheme brought claims against secondary actors that did business with Stanford rather than Stanford himself. Defendants included a lawyer who represented Stanford in an SEC and FINRA investigation, a trust company and its administrator that facilitated the sale of CDs to IRA investors, and insurance brokers who provided coverage to Stanford International.

The Fifth Circuit Held That the Fraud Alleged Was Not 'In Connection With' the Purchase and Sale of Any Covered Securities, Reversing the District Court's Application of SLUSA.

The district court determined that the investors' claims were based on misrepresentations made ''in connection with'' the purchase and sale of covered securities—and were thus barred by SLUSA—even though Stanford's CDs were never traded on a national exchange. According to the district court, the alleged fraud was *connected* to covered securities in two ways: first, the CDs were advertised to have been backed by investments in ''highly marketable securities issued by stable governments, strong multinational companies and major international banks,'' and second, some plaintiffs funded their investments in the CDs by selling

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[2] Notably, the PSLRA heightened the pleading standard for federal securities fraud claims, limited damages and attorneys' fees in securities class actions, provided protection for certain forward-looking statements, imposed sanctions for frivolous litigation, delayed discovery until after an action survived a motion to dismiss, and created the lead plaintiff and lead counsel appointment process.

[3] *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 88 (2006).

[4] In general, SLUSA provides that ''[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.'' 15 U.S.C. § 78bb(f)(1). Covered class actions include ''any single lawsuit in which . . . damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class . . . predominate over any questions affecting only individual persons or members.'' § 78bb(f)(5)(B). Any such action brought in state court may be removed to federal court and dismissed. § 78bb(f)(2).

[5] *Dabit* at 547 U.S. at 79-80.

[6] *Id.* at 85 (internal quotation marks omitted).

[7] *See id.*

[8] *Id.* at 89.

[9] Plaintiffs' Second Amended Class Action Complaint, *Troice v. Proskauer Rose, LLP*, No. 3:09-cv-01600, Dkt. No. 6, at 19.

[10] *Chadbourne & Parke LLP v. Troice*, 82 U.S.L.W. 4127, 2014 BL 51065, 134 S.Ct. 1058, 1064 (U.S. Feb. 26, 2014).

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nationally traded securities held in their retirements accounts.[11]

On appeal, the U.S. Court of Appeals for the Fifth Circuit reversed. The court held that ''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.''[12] Under that standard, the Fifth Circuit held that the claims did not arise from transactions in covered securities, but rather from representations that Stanford's non-covered CDs were safe investments. The covered securities purportedly backing the CDs were ''merely tangentially related to the heart, crux, or gravamen of the defendants' fraud.''[13]

The Supreme Court Affirmed, Holding That SLUSA Does Not Bar State Law Fraud Claims Arising From the Sale of Non-Covered Securities Purportedly Backed by Covered Securities.

In a 7-2 decision, the Supreme Court affirmed the Fifth Circuit's decision, holding that SLUSA did not apply to bar the claims at issue.

Justice Breyer, writing for the majority, explained succinctly 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 to sell a 'covered security.' ''[14] For purposes of this analysis, ''a connection matters where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security, not to purchase or to sell an uncovered security, something about which [SLUSA] expresses no concern.''[15]

Although *Dabit* held, for SLUSA purposes, that the fraud may coincide with either the investor's or another person's transaction in covered securities, the Court in *Chadbourne* explicitly held that the '''someone' making [the] decision to purchase or sell [covered securities] must be a party other than the fraudster.''[16] The Court reasoned that SLUSA's primary focus is on transactions in covered securities and the Court's prior decisions finding the ''in connection with'' requirement satisfied involved a victim (rather than the fraudster) who actually purchased, sold, or held covered securities.[17]

The Court hastily dismissed any concerns about the anticipated effect of its holding on market participants and their advisors, explaining that ''the only issuers, investment advisers, or accountants that today's decision will continue to subject to state-law liability are those who do not sell or participate in selling securities traded on U.S. national exchanges.''[18]

But that assertion begs the question: didn't the *Chadbourne* defendants effectively ''participate in selling'' nationally traded securities?

In Deciding *Chadbourne*, the Court Discounted Important Reasons to Limit its Holding to the Unique Facts Before it.

The Supreme Court's decision in *Chadbourne* failed to adequately recognize or address the consequences to secondary actors of narrowing SLUSA's reach to exclude the factual scenario before the Court. Such a holding contravenes the fair expectations of market participants and their advisors, as well as Congress's goal of maintaining uniformity in ligation involving the purchase or sale of covered securities.

Chadbourne indisputably involves transactions in covered securities (some may have been real, most were purported). After all, Stanford and his bank appeared to be market participants buying and selling securities in the same fashion as other legitimate investment companies. Each CD sold apparently resulted in additional securities purchased on the national exchanges. From the perspective of the *Chadbourne* defendants, the financial products at issue were simply another way for investors to gain exposure to nationally traded securities without directly trading in the markets.

Given those circumstances, the *Chadbourne* defendants could justifiably have expected litigation arising from Stanford's investment product to fall within the federal scheme.

The *Chadbourne* court didn't adequately address the consequences to secondary actors of narrowing SLUSA's reach to exclude the factual scenario at issue.

Congress intended that most securities fraud litigation proceed under federal law, and the securities at issue in *Chadbourne* were valueless but for Stanford's ability to consistently win in the markets. Investors could not have expected to receive the promised above-market returns any other way. As Justice Kennedy wrote in dissent, ''[t]he very essence of the fraud was to induce purchase of the CDs on the (false) promise that investors should rely on [Stanford's] special skills and expertise in making market investments in covered securities on their behalf. If promises related to covered securities are integral to the fraud in this direct way, federal regulation is necessary if confidence in the market is to be maintained.''[19]

The nature of plaintiffs' case also bears strong resemblance to litigation typically handled under the federal scheme (often under Section 10(b) of the Securities Exchange Act) against lawyers and advisors.[20]

[11] *Roland*, 675 F.3d at 510-11.
[12] *Id.* at 519-20 (citing *Madden v. Cowen & Co.*, 576 F.3d 957 (9th Cir. 2009)).
[13] *Id.* at 522.
[14] *Chadbourne*, 134 S. Ct. at 1066.
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.* at 1068 (emphasis removed).
[19] *Chadbourne*, 134 S. Ct. at 1077 (Kennedy, J., dissenting).
[20] *See, e.g., Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144, 149 (2d Cir. 2010) (alleging that a law firm that

In broad strokes, for both state law and federal claims, the plaintiffs must establish what the defendants knew or should have known about the primary fraudster and when those facts were discovered, if at all. *Chadbourne* may not be an archetype of federal securities litigation (like, for example, a stock-drop suit against an issuer), but *Dabit* made clear that not every peculiarity in a state law claim is relevant for SLUSA purposes. The claim need only closely resemble a typical claim under Section 10(b), and the claims in *Chadbourne* do.

Moreover, *Chadbourne* involves a Ponzi scheme, which are notoriously difficult to detect and will rarely, if ever, be discovered with assets sufficient to cover liabilities. As a result, Ponzi scheme litigation presents a particularly egregious risk to secondary actors, who—as the only non-judgment-proof entities in the wake of the scheme's collapse—will face the majority of ensuing litigation.

The Court recognized this kind of risk in *Central Bank of Denver v. First Interstate Bank of Denver, N.A.*, where it extinguished liability for private aiding and abetting claims under Section 10(b), in part, because of the risk that overly burdensome securities litigation would cause secondary actors to ''abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial.''[21] Such a result would have ripple effects in the securities markets, causing professionals to think twice before offering services to newer or smaller companies likely to generate securities litigation—also the type of companies that bring new and innovative ideas to the marketplace.[22] Moreover, the Court recognized that the additional costs incurred by secondary actors in securities litigation are ultimately passed to clients and investors—the very group that the federal securities laws are intended to protect.[23]

Certainly, secondary actors must be held to answer for their own fraudulent conduct, but in the context of a Ponzi scheme, the concern that secondary actors will bear the brunt of ensuing litigation following the collapse and exposure of the scheme militates in favor of keeping such litigation within the reach of federal law. Justice Kennedy expressed similar sentiment in his dissent, predicting that *Chadbourne* will open the door to litigation under state law ''[that] will drive up legal costs for market participants and the secondary actors, such as lawyers, accountants, brokers, and advisers, who seek to rely on the stability that results from a national securities market regulated by federal law.''[24] Minimizing unnecessary costs and uncertainty for market participants and their advisors is essential to maintaining efficient capital markets with low barriers to entry. Although the Court considered potential market externalities in *Dabit* when extending SLUSA's reach, the Court discounted those concerns in *Chadbourne*.

The consequences of *Chadbourne* are yet to be seen, but this much is certain: the Court missed an opportunity to decide the case narrowly on the facts before it—in other words, to extend SLUSA's reach to include Ponzi scheme litigation against secondary actors. Because those types of claims closely resemble traditional federal securities litigation and may create potentially devastating consequences to secondary actors if they were to be litigated in state courts, they are best kept within the federal scheme. Such an interpretation of SLUSA's reach would have satisfied the fair expectations of market participants and their advisors, and helped to maintain the uniformity within class action securities ligation that Congress envisioned as necessary to promote efficient capital markets.

advised a company in numerous fraudulent loan transactions violated Section 10(b)).

[21] *Central Bank of Denver v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188-90 (1994).

[22] *See id.*

[23] *See id.*

[24] *Chadbourne*, 134 S. Ct. at 1074 (Kennedy, J., dissenting).

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