SLUSA in the Age of Madoff

Skadden

09/29/15

Litigation arising out of Bernard Madoff's Ponzi scheme has generated multiple legal developments, including new case law regarding the Securities Litigation Uniform Standards Act of 1998 (SLUSA). SLUSA provides a powerful legal defense in securities class actions, often enabling defendants to secure dismissal at the outset of the case.

Congress enacted SLUSA to prevent plaintiffs from maintaining securities class actions under state law in order to circumvent stringent pleading requirements applicable to claims of federal securities fraud. To that end, SLUSA provides in pertinent part:

> No 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 misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security[.]

An issue that frequently arises under SLUSA is whether a state law claim satisfies the statute's "in connection with" requirement. In other words, does the claim allege a misrepresentation "in connection with" the purchase or sale of a covered security (one that is traded or registered for trading on a national exchange)? In the seminal case *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit,* the U.S. Supreme Court construed the requirement broadly, finding that the requisite connection exists when a claim alleges a misrepresentation that "'coincide[s]' with a securities transaction — whether by the plaintiff or by someone else."

Dabit, however, left open the question — which has loomed large in Madoff cases — of whether "someone else" means "anyone else." Before his arrest, Madoff's clients principally were hedge funds that authorized Madoff to buy and sell "covered securities" on their behalf. The plaintiffs in the Madoff cases, however, typically have not been Madoff's former hedge fund clients. Rather, they principally have been investors in those funds (feeder funds) and, consequently, had only indirect exposure to Madoff's investment strategy, which they obtained by acquiring restricted securities issued by the funds in private placement transactions. In many of the cases, the plaintiffs alleged state law claims asserting that they were induced to invest in feeder funds by misrepresentations made by the funds' managers and others regarding the legitimacy of Madoff's operations and investment strategy. In response to threshold motions made by defendants seeking dismissal of those claims, plaintiffs argued in part that their purchases of uncovered hedge fund securities were removed from — and, therefore, not "in connection with" — Madoff's purported investments in covered securities on behalf of the funds.

While lower courts were grappling with this issue, the Supreme Court rendered its decision in *Chadbourne & Parke LLP v. Troice*, a case stemming from the Stanford Ponzi scheme. In that decision, the Court held that the "someone else" referenced in the *Dabit* opinion did not mean anyone else but, rather, only persons other than the fraudster who bought or sold covered securities. The Second Circuit then applied *Troice* to rule that the requirements of SLUSA may be satisfied when the "someone else" induced to engage in a challenged securities transaction is an indirect purchaser of covered securities — namely, an investor in hedge funds managed by Madoff. In re Herald, Primeo & Thema.

Herald is one of a number of significant SLUSA rulings handed down in Madoff-related litigation, which also include the following:

- A large group of plaintiff investors cannot necessarily avoid SLUSA preclusion by filing several related lawsuits, each naming fewer than 50 plaintiffs, in different courthouses located in the same state. If and when those cases are transferred to a single

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Seth M. Schwartz
New York
212.735.2710
seth.schwartz@skadden.com

Jason C. Vigna
New York
212.735.3587
jason.vigna@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

judge and are coordinated in any way, they become "covered class actions" for purposes of SLUSA. *Spectrum Select II, L.P. v. Tremont Group Holdings, Inc.*

- To satisfy the "alleging … a misrepresentation" prong of SLUSA, the alleged misrepresentation or other "false conduct" must be made or committed by a named defendant (not an unnamed third party), and proof of such conduct must be "essential to the success of the state law claim" — although not necessarily an essential element of the claim. *In re Kingate Mgmt. Ltd. Litigation*.
- A state law claim alleging a false promise to engage in covered securities transactions may be precluded under SLUSA even if no such transactions are actually executed. *In re Herald.*
- SLUSA preclusion must be determined on a claim-by-claim basis. When only one of several state law claims alleged in the complaint is subject to SLUSA, only that claim can and must be dismissed pursuant to the statute, and the balance of the action may proceed. *In re Kingate.*

Although many questions arising under SLUSA have been addressed in Madoff litigation, several remain unresolved. For example, after *Kingate,* the law awaits further development on the question of when an alleged misrepresentation will be deemed essential to the success of a state law claim, but not an essential element of the claim. Another issue, which also surfaced in Kingate, is whether SLUSA preclusion of state law claims brought by foreign investors amounts to an impermissible extraterritorial application of the statute. The district court in *Kingate* answered this question in the negative, and the Second Circuit affirmed on this point *sub silentio*. We expect to see further litigation on this issue, particularly in cases brought by investors in offshore hedge funds contemplating transactions in covered securities. In the meantime, litigation in the aftermath of the Madoff debacle has clarified the scope of SLUSA and strengthened the defense by expanding its application to putative class securities claims alleged under state law.