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White Collar Crime

SLUSA Cases That Will Be Heard by the Supreme Court

An overview of some litigation spawned by the Allen Stanford Ponzi scheme

By Lois Yurow

This fall, the U.S. Supreme Court will hear arguments in three consolidated cases arising from the Allen Stanford Ponzi scheme. The petitioners in *Chadbourne & Park LLP v. Troice*, *Willis of Colorado Inc. v. Troice* and *Proskauer Rose LLP v. Troice* are challenging the restrictive application of the Securities Litigation Uniform Standards Act, announced by the Fifth Circuit in *Roland v. Green*, 675 F.3d 503 (5th Cir. 2012). If the Fifth Circuit's decision is affirmed, non-issuer participants in securities transactions, including lawyers, auditors and investment managers, can expect to be named more frequently in cases under state law.

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The History of SLUSA

The Securities Litigation Uniform Standards Act (SLUSA), 15 USC § 78bb, was enacted in 1998 to solve problems inadvertently created by the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. 104-67. Congress passed the PSLRA to deter frivolous class actions alleging securities fraud. To that end, the PSLRA requires more particularity in pleadings, imposes a stay on discovery while a court considers motions to dismiss, and ensures that an appropriate plaintiff, rather than a lawyer's hand-picked "client," represents the class in any case that moves forward.

After the PSLRA made actions under federal securities law more difficult, many plaintiffs decided to seek relief under state law. For example, the congressional record supporting SLUSA shows that in the first six months of 1996, securities-related claims under California law (previously nominal in number) increased by a factor of five.

SLUSA prevents plaintiffs from circumventing the PSLRA in two ways. First, SLUSA provides:

> No covered class action [any action seeking damages for more than 50 people] 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 [a security that is traded nationally and listed on a national securities exchange]; 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.

Second, SLUSA provides that covered class actions filed in state court are removable to federal court, where they may be dismissed. In short, SLUSA effectuates Congress' intent to drive all class actions involving alleged fraud and nationally traded securities into federal court to be resolved under federal law.

The Allen Stanford Ponzi Scheme

Beginning in the 1990s, various Stanford entities sold certificates of deposit (CDs) issued by an Antigua-based affiliate, Stanford International Bank (SIB). The sellers promised high rates of return, and assured buyers that the CDs were backed by safe, liquid investments issued by "stable governments, strong multinational companies, and major international banks" (in other words, covered securities). In reality, SIB used the proceeds from new sales of CDs to make interest and redemption payments on existing CDs. Roughly 80 percent of SIB's remaining assets were invested in unregulated (and illiquid) private equity and real estate deals, or appropriated by Mr. Stanford for other purposes. Ultimately, SIB and the other Stanford entities became insolvent.

The Lawsuits

Roland v. Green is a proxy for numerous lawsuits. Two sets of investors sued several Stanford affiliates (including the custodian for IRA purchasers of the CDs and the custodian's employees and investment advisers) in Louisiana state court, under Louisiana law. Among other things, the plaintiffs alleged the defendants made misrepresentations that induced the plaintiffs to purchase CDs. These actions were removed to the Northern District of Texas when the defendants argued that SLUSA precluded the state court from hearing them. The plaintiffs moved to remand.

The *Troice* plaintiffs brought two separate actions — one against Willis (SIB's insurance brokers) and one against Proskauer and Chadbourne & Parke (SIB's lawyers) — in the Northern District of Texas, under Texas law. Among other things, the plaintiffs alleged that Willis made misrepresentations that induced them to purchase CDs, and the law firms aided and abetted the fraud. Willis and the law firms moved to dismiss because of SLUSA.

The district court judge, who was handling these four cases and others arising from the Stanford scheme, selected one case — *Roland v. Green* — to decide whether SLUSA preclusion should apply. Although the SIB-issued CDs were not covered securities for purposes of the statute, the district court held there were sufficient misrepresentations "in connection with" covered securities to warrant preclusion. The court dismissed all four cases, and the plaintiffs appealed to the Fifth Circuit, where the actions were consolidated.

The Fifth Circuit's Opinion in *Roland v. Green*

The court's opinion focuses on the meaning of SLUSA's phrase "in connection with the purchase or sale of a covered security." Quoting *Merrill Lynch v. Dabit*, 547 U.S. 71 (2006), which found that Congress intended to import into SLUSA the meaning of "in connection with" applied in Rule 10b-5 cases, the Fifth Circuit stated, "it is enough that the fraud alleged `coincide' with a securities transaction." In addition, the Supreme Court "has stated that 'in connection with' must be interpreted broadly ... [but not] so broadly as to convert every common-law fraud *that happens to involve [covered] securities* into a violation of § 10(b)" (quoting *SEC v. Zandford*, 535 U.S. 813 (2002)).

Opining that the Supreme Court's decisions interpreting "in connection with" are "not particularly descriptive," the Fifth Circuit turned to decisions by other federal circuits discussing "what is sufficiently connected/coincidental to a transaction in covered securities to trigger SLUSA preclusion." The court also reviewed cases with similar fact patterns — where the plaintiffs purchased uncovered securities ("like a CD or a share in a 'feeder fund'") that have "some relationship ... to transactions (real or purported) in covered securities." Ultimately, the Fifth Circuit adopted a test articulated by the Ninth Circuit: "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*" (quoting *Madden v. Cowen*, 576 F.3d 957 (9th Cir. 2009)).

Turning first to the cases against the nonlaw firm defendants, the court acknowledged the alleged misrepresentations about the presence and quality of covered securities in SIB's portfolio, but found those statements to be "merely tangentially related" to the fraud, not "more than tangentially related." Instead, the court found that the "heart" of the fraud lay in the multitude of other misrepresentations (about things like liquidity and regulatory supervision) allegedly made to assure purchasers that the CDs were a sound investment. In addition, the court noted that "[t]he CDs ... promised a fixed rate of return not tied to the success of any of SIB's purported investments." Consequently, unlike investors in a feeder fund, for example, purchasers did not buy the CDs as an indirect means of acquiring covered securities. Finally, the court was not impressed that some plaintiffs sold covered securities in order to buy the CDs, because those sales were not central to the fraud.

Since the defendants' alleged fraud was not "more than tangentially related" to transactions in covered securities, the actions were not precluded by SLUSA and were remanded to state court. Finding that the alleged conduct of the law firms was even farther removed from the purchase or sale of covered securities, the court remanded that case to the district court.

Appeal to the Supreme Court

The Supreme Court granted certiorari in the *Troice* cases to consider "[w]hether SLUSA precludes a state-law class action alleging a scheme of fraud that involves misrepresentations about transactions in SLUSA-covered securities." The court declined to hear arguments about whether SLUSA precludes aiding and abetting claims.

Amicus briefs were filed by the United States, DRI-The Voice of the Defense Bar, the Securities Industry and Financial Markets Association, and a Louisiana law firm named in an aiding-and-abetting action under Texas law arising from the Stanford Ponzi scheme. All four briefs urge the court to overturn the Fifth Circuit, making essentially the same three arguments. First, SLUSA refers to "a misrepresentation or omission," which means a single alleged false statement about a covered security requires preclusion, even if the bulk of the complaint addresses other misdeeds. Amici (and the appellants) want the court to announce this as a bright-line test so "in connection with" is not left to interpretation in the lower courts. Second, if artfully pleaded cases evade SLUSA preclusion and proceed in state courts while other cases arising from the same facts proceed in federal courts, there will be inconsistent results that make the U.S. capital markets less certain, and therefore less competitive. Third, the Fifth Circuit's analysis will encourage more aiding-and-abetting claims against third parties — claims that expressly are prohibited under federal law — especially where the actual wrongdoer is insolvent.

If the Decision Is Affirmed

The third argument should be of great concern to service providers. As explained in the DRI brief:

> [T]he Fifth Circuit's approach would pave the way for expanded state-law litigation against law firms, auditors, and other third-party professional services firms for aiding and abetting misstatements by their clients. These kinds of lawsuits — which often attempt to shift the entire cost of an investment-related fraud to a third party — are fraught with risk and impose costs that are inevitably passed on to direct participants in U.S. capital markets.

For example, new entities may find it difficult to retain lawyers and auditors because of the concern that untested businesses are more likely to end up insolvent, leaving investors looking for someone else to sue.

Hedge funds and other investment vehicles that aren't themselves covered securities, and the professionals who run those enterprises, also may be named more frequently in state law actions. ■