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Expert Analysis

SLUSA in the Second Circuit After Supreme Court's Troice Decision

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On Feb. 26, 2014, the U.S. Supreme Court decided *Chadbourne & Park v. Troice*, 134 S. Ct. 1058. It is the latest of three cases the court has decided interpreting the Securities Litigation Uniform Standards Act, or SLUSA, *Troice* is also the latest of several Supreme Court decisions interpreting the "in connection with" phrase that appears in both SLUSA and Section 10(b) of the Securities Exchange Act. That phrase more than any other determines whether an alleged fraud is sufficiently connected to the purchase or sale of securities that it can be a basis for a securities suit.

Troice, however, should not have a significant impact on the meaning of that phrase because it imposes a limitation that arises from the unique circumstances of that case. This limited impact can be seen by examining litigation arising from the fraud perpetrated by Bernard Madoff. Madoff's fraud, like the fraud at issue in *Troice*, raises potential "in connection with" issues because many of the parties that invested with Madoff through feeder funds did not receive the type of securities that can form the basis of a SLUSA defense.

One such case, *Trezziova v. Kohn (In re Herald)*, 730 F.3d 112 (2d Cir. 2013), is awaiting a decision by the U.S. Court of Appeals for the Second Circuit on plaintiffs' petition for rehearing. *Troice* should not affect the ultimate resolution of that case. Indeed, another recent Madoff decision—*Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Investment Securities LLC)*, 721 F.3d 54 (2d Cir. 2013) (*In re Madoff*)—should have a more direct impact on SLUSA litigation going forward.

SLUSA

SLUSA was passed in 1998 to insure that class actions involving nationally traded securities proceed in federal court under federal securities law. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 82 (2006). It accomplishes that by allowing for the removal of cases to federal court and limiting a plaintiff to federal causes of action. But SLUSA applies only to those cases that fall within its reach—specifically, any "covered class action" where fraud is alleged "in connection with the purchase or sale of a covered security." 15 U.S.C. §78bb(f)(1). Put generally, covered securities are securities traded on national exchanges, and covered class actions are actions where damages are sought either on a class basis or on behalf of 50 or more persons. SLUSA's reach therefore is determined principally by the phrase "in connection with," which also appears in the main antifraud provision of the Exchange Act, Section 10(b).

The Second Circuit will have a chance to consider the impact of 'Troice' in a Madoff-related case, 'In re Herald.'

The Supreme Court has given this phrase a "broad interpretation," e.g., *Dabit*, 547 U.S. at 85, indeed, a construction broad enough to capture fraud in lying about whether money will be used to invest in securities. See *SEC v. Zandford*, 535 U.S. 813, 820–22 (2002). The phrase is flexible enough to encompass a purchase or sale by anyone; it need not be the plaintiff. e.g., *Dabit*, 547 U.S. at 85. As a result, SLUSA may still bar suits even when there is no federal claim that could be brought. *Dabit*, for example, involved a claim by a putative class of stockowners who allegedly were induced to hold securities they already owned. Because they had only held, and not bought or sold stock, the class could not state a federal claim. Yet the Supreme Court held that the class could not bring a state fraud claim despite the class not having an alternative remedy. 547 U.S. at 88.

The Troice Case

The Troice decision, like the Dabit decision before it, interprets the "in connection with" phrase. *Troice* involved allegations brought by customers that purchased certificates of deposit offered by Stanford International Bank (SIB), which was run by convicted fraudster Allen Stanford. Everyone agreed that the certificates of deposit that the customers bought were not themselves covered securities. But Stanford also misrepresented that the certificates of deposit were, in the words of the Supreme Court, "backed by covered securities."

The Supreme Court held that this set of allegations did not satisfy SLUSA's "in connection with" requirement. It reasoned that, in order for a misrepresentation to be "in connection with" the purchase or sale of a security, the misrepresentation must be "material to a decision by one or more individuals (other than the fraudster) to buy or sell a 'covered security.'" 134 S. Ct. at 1066. Applying this rule to the allegations before it, the court held that SLUSA did not apply because the statements were not material to anyone's investment decision in covered securities, except perhaps decisions made by SIB. Id. at 1071–72.

As the court recognized, however, if the misrepresentation were material to transactions by "some other person," SLUSA's "in connection with" requirement would be satisfied. Id. at 1071. But

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see Opinion, *In re Tremont Sec. Law, State Law, and Ins. Litig.*, No. 08 Civ. 11117 (SDNY April 14, 2014). The court had so held in *Dabit*, which *Troice* construed as also involving purchases or sales by unnamed third parties. See id. at 1066. Members of the court returned to this point again and again during oral argument in *Troice*.[1]

This should minimize *Troice's* impact, as it is a rare case where SLUSA will be invoked and the fraud was not material to someone's decision to purchase a security. The court in *Troice* was asked to consider the "in connection with" jurisprudence it has developed in light of an "unusual fact pattern."[2] It did so by formulating a "limiting principle" on that jurisprudence. *Troice*, 134 S. Ct. at 1072 (Thomas, J., concurring).

'In re Herald'

The limited impact of that "limiting principle" should be on display in the remaining litigation arising from Madoff's fraud. Like Stanford, Madoff made false promises that he would invest customer money in covered securities but he never actually made such purchases. This similarity was not lost on the Supreme Court: Madoff's name was invoked 19 times during the oral argument in the Troice case. Unlike Stanford, however, Madoff did not sell CDs but rather brokerage services in which he purported to trade covered securities.

The Second Circuit will have a chance to consider the impact of *Troice* in a Madoff-related case, *In re Herald*, 730 F.3d 112, which is pending before the Second Circuit on a petition for rehearing. The Second Circuit held that claims by investors in foreign feeder funds against banks alleged to have been involved in Madoff's fraud were barred by SLUSA. It reasoned that, while all agreed that the investments in the feeder funds themselves were not "covered securities," the claims were nevertheless barred because Madoff "indisputably engaged in *purported* investments in covered securities"—even though Madoff "may not have actually executed [these] pretended securities trades." Id. at 118–19 (emphasis added). The Second Circuit postponed ruling on the plaintiffs' petition for rehearing until *Troice* was decided and has requested briefing from the parties in light of the decision.

The Second Circuit's reasoning in *Herald* is correct, and that reasoning should not be affected by *Troice*. The key is that Madoff "indisputably engaged in purported investments in covered securities." That is, he led those that invested directly with him to believe that he was going to invest their money in securities. It was established in *Zandford* that when parties are "'duped into believing' that the defendant would 'invest their assets in the stock market,'" the "in connection with" requirement is satisfied. *Troice*, 134 S. Ct. at 1066–67 (describing holding parenthetically). That is exactly what Madoff did to those that invested with him directly. And, because the Herald plaintiffs' alleged losses spring from the same fraud, SLUSA should bar their claim as well. *Dabit*, 547 U.S. at 85. But this result follows from the Supreme Court's decisions in *Zandford* and *Dabit*. *Troice* contributes little to the analysis because there were many other people who were duped by Madoff into investing with him.

Madoff led those that invested directly with him to believe that he was going to invest their money in securities. It was established in 'Zandford' that when parties are "'duped into believing' that the defendant would 'invest their assets in the stock market,'" the "in connection with" requirement is satisfied.

'In re Madoff'

Herald therefore should have little impact on SLUSA litigation going forward. Instead, another 2013 Second Circuit decision arising from the Madoff fraud should more directly impact future SLUSA litigation in the Second Circuit. *Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Investment Securities)*, 721 F.3d 54 (2d Cir. 2013) (*In re Madoff*), does not mention SLUSA; but it speaks to an issue that comes up in many SLUSA cases.

That issue is whether SLUSA precludes claims or entire cases. In the Second Circuit, courts often view it as "the law of this Circuit" that SLUSA preclusion must be decided on a claim-by-claim basis. E.g., *LaSala v. Bank of Cyprus Public Co.*, 510 F.Supp. 246, 274 (SDNY 2007). Courts view the matter as settled because the Second Circuit so ruled in the Dabit case that went up to the Supreme Court. See *Dabit v. Merrill Lynch, Pierce, Fenner & Smith*, 395 F.3d 25 (2d Cir. 2005). While the Supreme Court disagreed with some of the Second Circuit's reasoning in its Dabit decision, it did not consider the Second Circuit's holding that SLUSA applied claim by claim.

What the Supreme Court did do, however, is vacate the Second Circuit's decision. And that brings one back to the *In re Madoff* decision. As the Second Circuit observed in *Madoff*, "vacatur dissipates precedential force." 721 F.3d at 68. Lawyers defending SLUSA suits should be careful not to give the Second Circuit's Dabit decision the same kind of "half-life" that vacated decisions sometimes enjoy. Id. at 69. Reasoning in the Second Circuit's Dabit decision—even reasoning that the Supreme Court did not address—no longer has precedential effect, and the question of whether SLUSA precludes claims or actions is an open one in the Second Circuit.

The better answer is that SLUSA precludes entire actions. "SLUSA's plain language…suggests that it does." *Atkinson v. Morgan Asset Mgmt., Inc.*, 658 F.3d 549, 555 (6th Cir. 2011). SLUSA speaks of disallowing certain "covered class actions," which itself denotes that the statute applies to actions, rather than claims. Moreover, "covered class actions" is a defined term in SLUSA. And it is defined to be either a "single lawsuit" or a "group of lawsuits."

The Third and Ninth Circuits have both reached the opposite conclusion, emphasizing the Supreme Court's reasoning in *Jones v. Bock*, 459 U.S. 199 (2007). See *Proctor v. Vishay Intertechnology*, 584 F.3d 1208, 1222 (9th Cir. 2009); *In re Lord Abbett Mutual Funds Fee Litigation*, 553 F.3d 248, 255–56 (3d Cir. 2009). *Jones* was a case arising from the Prison Litigation Reform Act (PLRA), where the court held that the statute's use of the word "action" did not prevent it from considering whether claims were exhausted on a claim-by-claim basis, which it viewed as the general rule. Id. at 221. The PLRA, however, simply uses the word "action." SLUSA, by contrast, defines the term "covered class action" by reference to lawsuits, not just claims. That should be enough of an "indication" of what Congress meant in SLUSA. Id.

As courts start to apply *Troice*, one should expect to see it supplementing other "in connection with" cases like *Dabit* and *Zandford*, but not forming the centerpiece of the analysis. On the other hand, one case that should start to figure in the center of decisions regarding SLUSA is *In re Madoff*, as defendants ask courts to reconsider applying SLUSA to lawsuits instead of only claims.

1. See Transcript of Oral Argument in *Chadbourne & Park v. Troice*, No. 12-79 (Oct. 7, 2013) at 10 ("In all of our cases, there's been something to say when somebody can ask the question, how has this affected a potential purchaser or seller in the market for the relevant securities? And here, there's nothing to say." (question from Justice Elena Kagan)); id. at 18 ("It doesn't have to be the plaintiff's, but it has to be somebody's." (question from Justice Antonin Scalia); id. at 19 ("But somebody else—somebody else was, right?" (question from Chief Justice John Roberts)).

2. Brief of the U.S. as Amicus Curiae at 8 (Dec. 14, 2012).