Secondary Actors in Securities Transactions Beware: The Supreme Court May Have Aided and Abetted the Prospect of Increased State Court Litigation

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Secondary actors in securities transactions, such as lawyers, accountants, investment advisers and brokers, should be on alert in the wake of the Supreme Court's recent decision in *Chadbourne & Parke v. Troice*, 134 S. Ct. 1058 (2014), which limits the application of (and protections provided by) the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), 15 U.S.C. § 78bb(f)(1). Historically, SLUSA precluded most state-law securities fraud class actions, reflecting the Congressional intention to centralize such litigation in federal court. In *Chadbourne* the U.S. Supreme Court narrowed SLUSA's scope, holding that it does not preempt certain state-law class action litigation against secondary actors. In so doing, the Court allowed the state-law claims to proceed against two insurance brokers and two law firms.

Following this precedent, there could now be an increase in state-law litigation against such secondary actors. For example, just this month, in light of the *Chadbourne* decision, a group of investors with claims related to the Madoff Ponzi scheme was given the opportunity to reassert state-law claims that were previously dismissed pursuant to SLUSA and the court raised the possibility that a major accounting firm could be reinstated as a defendant. *See In re Tremont Securities Law, State Law and Insurance Litigation*, No. 1:08-cv-11117 (S.D.N.Y. April 14, 2014) (TPG). Compounding the problem, under state law, defendants cannot take advantage of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), including its heightened pleading standards and caps on damages and attorneys' fees. Nor can they rely on Supreme Court precedent eliminating aiding and abetting liability under the federal securities laws.

The *Chadbourne* Decision

Chadbourne arose from Allen Stanford's multibillion Ponzi scheme where investors purchased certificates of deposit ("CDs") in the Stanford Investment Bank ("SIB"), believing they would be used to purchase lucrative assets, such as "highly marketable securities issued by stable governments [and] strong multinational companies." *Id.* at 1065. In other words, although the CDs were not themselves "covered securities," plaintiffs expected that they were backed by or would be used to purchase SLUSA covered securities. *Id.* at 1073. Instead, the proceeds from the CDs were used in a Ponzi scheme to repay earlier investors, to finance speculative investments, and to fund the fraudsters' elaborate lifestyles. *Id.* at 1064. The victims brought state-law class action suits asserting aiding and abetting liability against secondary actors who allegedly assisted Stanford and SIB's scheme.

Defendants moved to dismiss plaintiffs' claims, arguing that they were barred by SLUSA, which precludes state-law securities class actions where plaintiffs allege "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). In the past, the Supreme Court has broadly interpreted the "in connection with" requirement, resulting in relatively widespread preclusion of state-law securities class action litigation and requiring such actions to proceed pursuant to federal securities laws, which do not allow for aiding and abetting liability. Citing this precedent, defendants argued that the state-law claims against them concerned alleged fraud "in connection with" the purchase or sale of a "covered security," and were barred by SLUSA. However, the term "covered security" under SLUSA only includes securities traded on a national exchange. *Id.* at 1062 (citing §§ 15 U.S.C. § 78bb(f)(5)(E); 77r(b)(1)-(2)). Here, although the CDs purchased by SIB's investors were not covered securities as defined by SLUSA (they did not trade on a national exchange), they were allegedly backed by covered securities that made their investments more secure. *Id.* at 1065.

Faced with this issue, the Fifth Circuit held that the alleged falsehoods concerning SIB's assets were not falsehoods made "in connection with" the purchase or sale of a covered security. *Roland v. Green*, 675 F.3d 503 (5th Cir. 2012). Instead, the covered securities were "too tangentially related" to the "crux of the fraud to trigger" SLUSA preemption. *Id.* at 520-22. Following the Fifth Circuit's decision, the Supreme Court was required to determine how broadly to interpret the "in connection with" requirement and whether SLUSA "extend[s] further than misrepresentations that are material to the purchase or sale of a covered security." *Chadbourne*, 134 at 1066. In a 7-2 decision, the Supreme Court held that it does not. *Id.*

Justice Breyer's majority opinion explained 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.'" *Id*. The Court concluded that a "natural reading" of SLUSA's language suggests there must be a "connection that matters" – meaning that "the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security." *Id*. Additionally, the Court stated that the victims must have an "ownership interest" in the covered security for SLUSA to apply. *Id*. The fact that the plaintiffs purchased uncovered securities, and SIB was possibly going to purchase covered securities with plaintiffs' investments was not sufficient to bring their claims within the scope of SLUSA, and therefore the claims were not precluded.

In reaching this conclusion, the Court moved away from earlier precedent which explained that the phrase "in connection with" should be given "a broad interpretation" and would be satisfied by any deceptive practice that "touch[es] a securities transaction." *Id.* at 1069 (citations omitted). Notwithstanding its holding, the Court expressly stated that it was not departing from prior caselaw. It attempted to reconcile precedent by explaining that its prior cases would satisfy this new test because they all involved a false statement that was material to another individual's ownership interest in a covered security. *Id.* at 1066-67, 1069.

Justice Kennedy, in a dissent joined by Justice Alito, wrote that the "key question" to determining whether SLUSA applies is whether the misrepresentation coincides with the purchase or sale of a covered security. *Id.* at 1078. The dissent concluded that Stanford's misrepresentation met this criteria (*id.*) and reiterated that precedent required the phrase "in connection with" to "be construed flexibly," and that this approach was increasingly important to encompass new and more ingenious fraudulent schemes. *Id.* at 1073. The dissent disagreed with the majority's holding that the purchase or sale of securities must be made by someone other than the fraudster, arguing that such a requirement does not appear in SLUSA's plain text. *Id.* at 1081. In light of these concerns, the dissent warned that the Court's ruling will "narrow and constrict essential protection for our national securities markets." *Id.* at 1073.

Implications Of The Decision

Chadbourne may result in more state-law class actions against secondary actors, including professional service providers such as law firms, accountants, investment advisers and brokers, where the alleged fraud is in connection with an uncovered security. In addition to CDs, unregistered securities acquired in private transactions, among others, also may not be considered SLUSA covered securities. For example, in *Tremont*, the court explained that plaintiffs had purchased limited partnership interests in various funds, and therefore they had not acquired an ownership interest in covered securities. *Tremont*, at *7. As a result, their claims were not precluded by SLUSA.

The ruling in *Chadbourne* may provide plaintiffs with a significant opportunity to circumvent not only the PSLRA's protections, but also the protections provided in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) and *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008), where the Supreme Court barred investors from asserting aiding and abetting claims against secondary actors under federal law. Recognizing this possibility, the dissent cautioned that the decision "will subject many persons and entities whose profession it is to give advice, counsel and assistance in investing in the securities markets to complex and costly state law litigation based on allegations of aiding or participating in transactions that are in fact regulated by the federal securities laws." *Chadbourne*, 134 at 1074.

At this point, it is hard to predict to what extent this concern will materialize given that the decision only pertains to class actions involving securities not traded on U.S. national exchanges. Additionally, even without a SLUSA argument, defendants will be able to assert substantive defenses to the fraud claims brought under state law. Nevertheless, in the near term, litigation related to these types of matters is likely to rise.

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