Chadbourne & Parke v. Troice: The Supreme Court's opportunity to address SLUSA limitations

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Insurance companies providing coverage for securities claims and lawyers who defend against those claims are keeping tabs on the Supreme Court this term, closely following the court's review of three consolidated cases. These cases, *Chadbourne & Parke v. Troice*,[1] *Willis of Colorado v. Troice*[2] and *Proskauer Rose LLP v. Troice*,[3] all arise from the Allen Stanford scam.

Argument held
Oct. 7

Stanford has gone from being recognized by Forbes as one of the richest men in America to an inmate, serving a 110-year prison sentence. Stanford's federal conviction was based upon the sale of fraudulent certificates of deposit supposedly issued by his Antiguan bank, Stanford International Bank. The allegations of losses to investors in this Ponzi scheme rose to approximately $7 billion.

Stanford's personal use of the "investments" included the purchase of a fleet of airplanes and helicopters. The Securities and Exchange Commission filed suit against Stanford. The 20,000 victims of his criminal activity have been left with nothing except for their legal claims. Furthermore, numerous lawsuits were filed, including class action lawsuits against two law firms, Chadbourne & Parke and Proskauer Rose LLP, as well as SIB's insurance broker, Willis of Colorado.

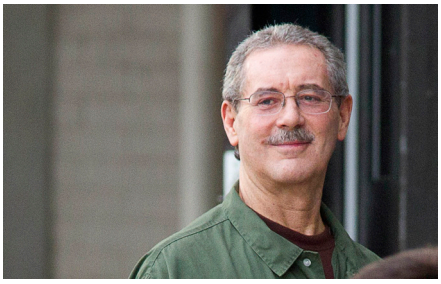
These class actions were filed in the U.S. District Court for the Northern District of Texas, and they were docketed along with another action that had been filed in Louisiana state court against businesses that were allegedly associated with the SIB activities. That Louisiana case had been removed to federal court in Louisiana and then transferred to the Northern District of Texas.

Question presented

Proskauer Rose LLP v. Troice, No. 12-88

Does the Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. §§ 77p(b), 78bb(f)(1), prohibit private class actions based on state law only where the alleged purchase or sale of a covered security is "more than tangentially related" to the "heart, crux or gravamen" of the alleged fraud?

While there were some variations in the claims, their premises were largely based on the SEC theory that SIB had sold certificates of deposit promising high interest to investors, and the CDs were backed by securities and liquid investments. In reality, there were no securities backing these instruments. The defendants argued successfully to the District Court that the Securities Litigation Uniform Standards Act precluded the lawsuits. That ruling was overturned, however, by the 5th U.S. Circuit Court of Appeals, in an interpretation that was consistent with the 9th Circuit's view but contrary to that of 11th Circuit's. Because of this split in the circuits, the Supreme Court granted the defendants' applications for review.



REUTERS/Richard Carson

Allen Stanford, shown here in 2012, has gone from being recognized by Forbes as one of the richest men in America to an inmate, serving a 110-year prison sentence.

The Securities Litigation Uniform Standards Act was enacted in 1998 as the second wave of efforts by Congress to reduce the number of securities fraud class-action lawsuits. The first legislative action in this direction was in 1995, when Congress passed the Private Securities Litigation Reform Act. The PSLRA impacted federal securities lawsuits that were filed alleging violations of the 1933 and 1934 acts. Because plaintiffs reacted to the PSLRA by pursuing class actions alleging violations of state laws, there was a need for further action.

This led to SLUSA, codified in 15 U.S.C. § 78bb(f), which says, "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) 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."

The issue in these cases is whether *covered securities* were involved in the scheme perpetrated by SIB. Covered securities are traditional, nationally traded securities, the

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Question presented

Willis of Colorado v. Troice, No. 12-86

The Securities Litigation Uniform Standards Act of 1998 precludes state law class actions that allege a misrepresentation or omission "in connection with" the purchase or sale of a covered security. 15 U.S.C. § 78bb(f)(1). The complaints at issue in this case plainly included such alleged misrepresentations. The District Court, applying 11th Circuit precedent, recognized as much and dismissed the complaints. However, the 5th Circuit disagreed and, purporting to apply the 9th Circuit's test, found the fact that the complaints included alleged misrepresentations in connection with a covered security insufficient to invoke SLUSA because the complaints also included other misrepresentations that were not made "in connection with" a covered securities transaction. In doing so, the 5th Circuit acknowledged that it was departing from the holding of the 11th Circuit and several other circuits.

The question presented is whether a covered state law class-action complaint that unquestionably alleges "a" misrepresentation "in connection with" the purchase or sale of a SLUSA-covered security nonetheless can escape the application of SLUSA by including other allegations that are farther removed from a covered securities transaction.

types which were purportedly backing the CDs issued by SIB. As the investigations disclosed, however, there were no such securities underlying the instruments.

Rather, the investors' funds were pooled and placed in either risky investments or Stanford's pockets. The District Court determined that because the investors had been supplied with information indicating "that the SIB CDs were backed, at least in part, by SIB's investments in SLUSA-covered securities," the SLUSA preclusion applied. Additionally, the court ruled that the allegations in the complaints were that there had been a "fraudulent scheme that coincided and depended upon the purchase or sale of covered securities."[4]

While the District Court used these conclusions to support its finding that SLUSA precluded the lawsuits, the 5th Circuit reversed, reviving the state law class-action claims. The essence of the 5th Circuit's ruling was that the SLUSA preclusion is only applicable when the covered securities action is shown to be "more than tangentially related to the purchase or sale of covered securities."[5]

The 5th Circuit first examined the claims against Willis and SEI (an adviser to a retirement fund that was found to be similarly situated as Willis). Those claims were made pursuant to the Texas Securities Act, alleging aiding and abetting violations of the law, and civil conspiracy.

Those claims said the Willis defendants misrepresented the quality of the CDs as safe and secure investments by claiming SIB was based in the U.S. and regulated by the federal government, insured by Lloyds, regulated by Antigua and subject to strict management and outside audit reviews. As to the investments, Willis allegedly said there would be high rates of return, as substantial as in the "double digits"; rates that exceeded those offered by U.S. banks; and that the portfolio consisted "of highly marketable securities issued by stable national governments, strong multinational companies and major international banks."

The 5th Circuit said the following:

> We find that the heart, crux, and gravamen of their allegedly fraudulent scheme was representing to the appellants that the CDs were a "safe and secure" investment that was preferable to other investments for many reasons. For example, as alleged by the Roland plaintiffs (one of the groups of Louisiana investors who sued in state court), the CDs were principally promoted as being preferable to other investments. This was due to their liquidity, their consistently high rates of return, and the fact that SEI and other regulators were keeping a watchful eye on SIB. Similarly, the so-called "safety and soundness letters" sent by the Willis defendants focused on the "professionalism" of SIB and the "stringent" reviews. That the CDs were marketed with some vague references to SIB's portfolio containing instruments that might be SLUSA-covered securities seems tangential to the schemes advanced by the SEI and Willis defendants.[6]

While the claims against Willis and SEI involved affirmative misrepresentations, the claims against the law firms did not, on their face, involve such allegations. Instead, the court described the "core allegation" as "that without the aid of the Proskauer defendants the Stanford Ponzi could not have been accomplished."[7] Yet, the court said it was evident "that there [we]re misrepresentations involved."[8]

The Court of Appeals wrote that the complaints were that the law firms "allegedly misrepresented to the SEC the commission's ability to exercise its oversight over Stanford and SIB."[9] Essentially, the claims were that these defendants "obstructed any chance of an SEC investigation uncovering the fraud, thereby allowing it to continue and harm."[10]

Comparing these claims with those made against the Willis defendants, the 5th Circuit found that "[t]hese alleged misrepresentations were one level removed from the misrepresentations made by SIB or the SEI and Willis defendants."[11] Still, the appellate court said, "the misrepresentations made by the Proskauer defendants are not more than tangentially related to the purchase or sale of covered securities, and therefore, SLUSA preclusion does not apply."[12]

There is broad recognition of the high stakes implicated by the issues presented in these appeals. Thomas C. Goldstein, counsel for plaintiffs, opened his argument before the Supreme Court with a request to the court:

> Write an opinion affirming and ... adopt[ing] the following rule, and that is, that a false promise to purchase securities for one's self in which no other person will have an interest is not a material misrepresentation in connection with the purchase or sale of covered securities.[13]

Plaintiffs have been supported in that position through *amicus* briefs, including those filed by:

- Sixteen law professors who teach and write about securities laws and

who said, "Petitioners' overly broad interpretation of SLUSA would preclude plaintiffs from filing class actions under state law despite the fact that, under well-established law, those same cases must be brought only under state law because they do not allege fraud in connection with securities traded on a national exchange."[14]

- The National Association of Bankruptcy Trustees, which argued in its brief against an "overly restrictive" interpretation of SLUSA, which, the association claims, would hamper its ability to "exercise their fiduciary duties."[15]
- A joint brief filed by the Public Investors Arbitration Bar Association, the AARP and the Network for Investor Action and Protection, which argued that a ruling denying the SLUSA exclusion would be critical for investor protection.[16]
- Occupy the SEC, which is comprised of financial professionals with decades of collective experience, concerned citizens and activists. This brief argued that the Supreme Court "should affirm the 5th Circuit by holding that SLUSA only precludes fraud class actions brought under state law where the crux of the alleged fraud has more than a tangential connection to a covered securities transaction."[17]

On the other hand, there was also considerable institutional support for the defendants. First, the federal government was invited by the court to file a brief in these cases at the petition stage because of its responsibility in enforcing the securities laws. The government maintained that the 5th Circuit's view would serve to diminish the proper coverage of SLUSA and invite the filing of lawsuits in a way that will be clearly contrary to Congress's intent in passing the statute.

Also, an *amicus* brief was filed in support of the petitioners by the Securities Industry and Financial Markets Association. SIFMA describes its "mission ... to support a strong financial industry while promoting investor opportunity, capital formation, job creation, economic growth and trust and confidence in the financial markets."[18]

In its brief, SIFMA said, "Congress's efforts to curb vexatious litigation in state law securities class actions by enacting SLUSA [should] not be compromised by plaintiffs who attempt creatively to plead around SLUSA preclusion and stricter uniform national federal securities standards."[19]

Not surprisingly, the oral argument in these cases ranged from considering the practical to what constitutes correct statutory construction. Justice Stephen Breyer spoke of the prospect of billions of securities actions if there were no controls. And Justice Elena Kagan wondered if there were no limitations; could there be a lawsuit "if people reach a prenuptial agreement and as part of the prenuptial agreement they agree that in a year, one party to the marriage is going to sell as many shares of Google stock and buy a home with it. Is that covered by the securities laws now?"[20]

Justice Antonin Scalia, however, pointed out that there were no real securities involved in the scheme, offering that, the claim "can't be in connection with a purchase or sale that has never occurred."[21] Also at issue during the oral argument was exactly how the plain wording of the statute should be interpreted, because, as Justice Samuel Alito viewed, "in connection with," as "open-ended."[22] He said to the assistant to the solicitor general, "So I don't know what you're going to get from the text of the statute."[23]

This securities case presents questions of public policy, statutory construction, legislative intent and consumer rights, all rolled into a not-so-tidy ball. There is little question that the underlying frauds which resulted in extreme losses devastated many. The issue, however, is whether that type of conduct can be the basis for civil litigation by private parties against those who engage in the marketing and sale of securities. This would also impact associated law firms and other service providers. Or, instead, will the government's efforts to halt the proliferation of these types of suits be successful? WJ

Question presented

Chadbourne & Parke v. Troice, No. 12-79

The Securities Litigation Uniform Standards Act precludes most state-law class actions involving "a misrepresentation" made "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A). The circuits, however, are divided over the standard for determining whether an alleged misrepresentation is sufficiently related to the purchase or sale of a covered security to satisfy the "in connection with" requirement. The 5th Circuit in this case adopted the 9th Circuit standard and held that the complaint here was not precluded by SLUSA, expressly rejecting conflicting 2nd, 6th and 11th circuit standards for construing the "in connection with" requirement, all of which would result in SLUSA preclusion here. Additionally, and also in conflict with several other circuits, the 5th Circuit held that SLUSA does not preclude actions alleging aiding and abetting of fraud in connection with SLUSA-covered security transactions when the aiders and abettors themselves did not make any representations concerning a SLUSA-covered security.

The question presented is:

Whether SLUSA precludes a state-law class action alleging a scheme of fraud that involves misrepresentations about transactions in SLUSA-covered securities.

NOTES

[1] *Chadbourne & Parke v. Troice,* No. 12-79, *cert. granted* (U.S. Jan. 18, 2013).

[2] *Willis of Colo. Inc. v. Troice,* No. 12-86, *cert. granted* (U.S. Jan. 18, 2013).

[3] *Proskauer Rose LLP v. Troice,* No. 12-88, *cert. granted* (U.S. Jan. 18, 2013).

[4] *Roland v. Green,* 675 F.3d 503, 513 (5th Cir. 2012) (quoting *Instituto De Prevision Militar v. Merrill Lynch,* 546 F.3d 1340, 1349 (11th Cir. 2008)).

[5] *Id.* at 522.

[6] *Id.*

[7] *Id.* at 524.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] Transcript of Oral Argument at 30, *Chadbourne & Parke v. Troice, Willis of Colo. Inc. v. Troice, Proskauer Rose LLP v. Troice*, (2013) (Nos. 12-79, 12-86 and 12-88), *available at* http://

www.supremecourt.gov/oral_arguments/argument_transcripts/12-79_8nj9.pdf.

[14] Brief for Sixteen Law Professors as Amici Curiae Supporting Respondents, *Chadbourne & Parke v. Troice, Willis of Colo. Inc. v. Troice, Proskauer Rose LLP v. Troice*, (2013) (Nos. 12-79, 12-86 and 12-88), *available at* http://sblog.s3.amazonaws.com/wp-content/uploads/2013/07/12-79-bsac-RichardPainter.pdf.

[15] Brief for the National Association of Bankruptcy Trustees as Amicus Curiae Supporting Respondents, *Chadbourne & Parke v. Troice, Willis of Colo. Inc. v. Troice, Proskauer Rose LLP v. Troice*, (2013) (Nos. 12-79, 12-86 and 12-88), *available at* http://www.americanbar.org/content/dam/aba/publications/supreme_court_preview/briefs-v2/12-79-12-86-12-88_resp_amcu_nabt.authcheckdam.pdf.

[16] *See* Brief for Public Investors Arbitration Bar Association, AARP, and Network For Investor Action And Protection as Amicus Curiae Supporting Respondents, *Chadbourne & Parke v. Troice, Willis of Colo. Inc. v. Troice, Proskauer Rose LLP v. Troice*, (2013) (Nos. 12-79, 12-86 and 12-88), *available at* http://www.americanbar.org/content/dam/aba/publications/supreme_court_preview/briefs-v2/12-79-12-86-12-88_resp_amcu_piaba-etal.authcheckdam.pdf.

[17] Brief for Occupy The SEC as Amicus Curiae Supporting Respondents, *Chadbourne & Parke v. Troice, Willis of Colo. Inc. v. Troice, Proskauer Rose LLP v. Troice*, (2013) (Nos. 12-79, 12-86 and 12-88), *available at* http://www.americanbar.org/content/dam/aba/publications/supreme_court_preview/briefs-v2/12-79-12-86-12-88_resp_amcu_oc-sec.authcheckdam.pdf.

[18] Brief for the Securities Industry and Financial Markets Association as Amicus Curiae Supporting Petitioners, *Chadbourne & Parke v. Troice, Willis of Colo. Inc. v. Troice, Proskauer Rose LLP v. Troice*, (2013) (Nos. 12-79, 12-86 and 12-88), *available at* http://www.americanbar.org/content/dam/aba/publications/supreme_court_preview/briefs-v2/12-79-12-86-12-88_pet_amcu_sifma.authcheckdam.pdf.

[19] *Id.*

[20] Transcript of Oral Argument at 9, *Chadbourne & Parke v. Troice, Willis of Colo. Inc. v. Troice, Proskauer Rose LLP v. Troice*, (2013) (Nos. 12-79, 12-86 and 12-88), *available at* http://www.supremecourt.gov/oral_arguments/argument_transcripts/12-79_8nj9.pdf.

[21] *Id.* at 28.

[22] *Id.* at 47.

[23] *Id.*

Carpenter asks high court to reinstate asbestos intentional-harm suit

A carpenter says in a petition for review filed with the U.S. Supreme Court that the Philadelphia Housing Authority deprived him of his civil rights by intentionally exposing him to asbestos while he was employed by the agency.

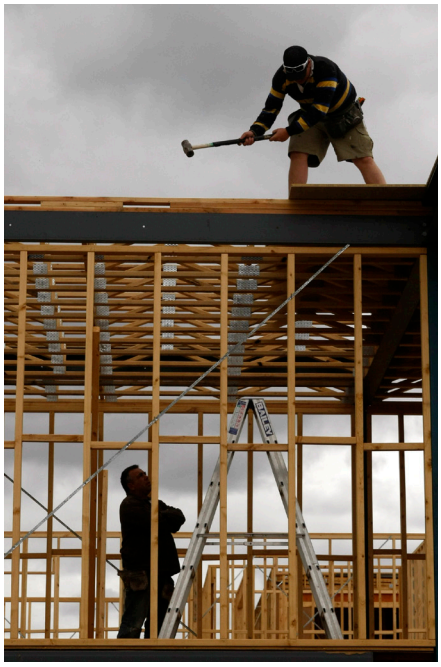
Smith v. Philadelphia Housing Authority et al., No. 13-511, petition for cert. filed (U.S. Oct. 18, 2013).

Petitioner Robert Smith based his claim against the city authority on 42 U.S.C. § 1983, which makes governments liable for actions that under the color of state law deprive citizens of their rights guaranteed by the U.S. Constitution.

Petition filed
Oct. 18

"The United States Supreme Court and the federal courts have routinely held a constitutional tort, in which a person is deprived of his right to bodily integrity, can be the basis for a viable Section 1983 claim," Smith says in his Oct. 18 petition.

Smith "encountered what he believed to be asbestos" while working as a carpenter for the Philadelphia Housing Authority from March 2009 until January 2010, according to the petition.



REUTERS/Mick Tsikas

The plaintiff believes he encountered asbestos while working as a carpenter for the Philadelphia Housing Authority, the complaint says.

> "The United States Supreme Court and the federal courts have routinely held a constitutional tort, in which a person is deprived of his right to bodily integrity, can be the basis for a viable Section 1983 claim," petitioner Robert Smith says.

The PHA deliberately chose not to remove Smith from the area and "specifically agreed to conceal the facts relating to asbestos exposure," the petition says.

Smith says he was "once a healthy individual" but "must now ingest numerous medications simply to remain alive."

He sued the PHA and its executives in the U.S. District Court for the Eastern District of Pennsylvania, claiming the agency breached its duty of care and violated his constitutional rights as codified in Section 1983.

The defendants asserted they had no constitutional duty to provide a safe workplace.

The District Court agreed and dismissed the suit. *Smith v. Phila. Hous. Auth.*, 2012 WL 3263593 (E.D. Pa. 2012).

The 3rd U.S. Circuit Court of Appeals affirmed. It said Smith did not plead a "cognizable constitutional or federal law violation." *Smith v. Phila. Hous. Auth.*, 2013 WL 3802808 (3d Cir. July 23, 2013).

This petition for writ of *certiorari* followed.

Smith says the defendants' "alleged conduct aimed to cause him harm and this particular claim does sufficiently establish the basis for a Section 1983 claim."

Smith says motions to dismiss should be granted only in rare circumstances and