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EXPERT ANALYSIS

Chadbourne & Parke v. Troice: Will the Supreme Court's Narrow Statutory Interpretation Open A Wide Door to Securities Lawsuits?

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The U.S. Supreme Court issued its opinion Feb. 26 in a consolidated appeal related to the collapse of Allen Stanford's financial network. *Chadbourne & Parke v. Troice*, No. 12-79; *Willis of Colo. v. Troice*, No. 12-86; *Proskauer Rose LLP v. Troice*, No. 12-88, 134 S. Ct. 1058 (Feb. 26, 2014). Significantly, the court agreed with the 5th U.S. Circuit Court of Appeals that a federal statute does not bar the underlying lawsuits.

The underlying lawsuits were filed after Stanford's operation was exposed as an immense Ponzi scheme generating $7 billion in losses, and after a number of criminal, regulatory and civil actions were pursued. Stanford's federal prosecution for fraud was only one of these actions.

In addition, Stanford's victims sought relief in various lawsuits, including class actions against two law firms allegedly associated with Stanford's operations, Chadbourne & Parke and Proskauer Rose LLP, as well as Stanford International Bank's insurance broker, Willis of Colorado. In the three class actions before the Supreme Court, the plaintiffs used state law, arguing that the law firms and the broker aided Stanford in the scheme to sell the plaintiffs certificates of deposit in SIB.

The District Court dismissed the lawsuits, saying they were precluded by the Securities Litigation Uniform Standards Act of 1998. SLUSA forbids large securities class actions "based upon the statutory or common law of any state" in which the plaintiffs allege "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." A covered security is one that is traded on a national exchange, and the District Court admitted that the certificates of deposit were not covered securities. SIB's misrepresentation that its holdings in covered securities made investments in its uncovered securities more secure, however, provided the requisite "connection" (under SLUSA) between the plaintiffs' state law actions and transactions in covered securities.

After the 5th Circuit reversed the District Court's decision based on the view that the misrepresentations concerning SIB's holdings in covered securities were too tangentially related to the fraud to trigger SLUSA preemption, the Supreme Court granted *certiorari*.

The Supreme Court's majority opinion, authored by Justice Stephen Breyer, affirmed the 5th Circuit's holding. In framing the issue, the court said the plaintiffs were claiming they had purchased "uncovered securities" that were falsely represented to be backed by covered securities. Justice Breyer said, "Under these circumstances, we conclude the act does not apply."

The complaints in the lawsuits did not have a direct connection with covered securities. In one of the complaints, the plaintiffs alleged that they purchased CDs from SIB because of representations that the instruments were "safer" than CDs issued by a U.S. bank and could be redeemed on demand.

Those plaintiffs alleged that Stanford had "touted the high quality of SIB's investment portfolio," boasts that were material to their purchases. In another complaint, the purchases were, again, of supposedly liquid investments supported by high-grade bonds and stocks. The two other complaints offered similar allegations about the misrepresentations made to them.

The focal point of the court's opinion was on the phrase "in connection with the purchase or sale of a covered security" in SLUSA Section 78bb(f)(1)(A). The court found that the phrase did not apply to the class actions. The majority acknowledged that its interpretation of the phrase was a narrow one, but found a number of bases for that view.

First, the majority pointed out that the act focuses on "covered securities" and not uncovered securities that have a relationship with covered securities. Next, the court was able to look to the plain language of SLUSA and its use of the term "covered security." Third, the court's precedents interpreting the statute were consistent with this narrow view. In other securities cases where the court found fraud in connection with a transaction involving a security, the court said the victims had "*an ownership interest*" in a covered security. The fourth basis for the court's view came from its reliance on the Securities Exchange Act of 1934 and the Securities Act of 1933, both of which are designed to control transactions involving covered securities.

Finally, and perhaps of greatest significance, was the court's concern that interpreting "in connection with" more expansively would impact state law claims concerning fraud. The court said if it ruled so as to limit state law claims, it "would interfere with state efforts to provide remedies for victims of ordinary state law frauds. A broader interpretation would allow the Litigation Act [SLUSA] to cover, and thereby to prohibit, a lawsuit brought by creditors of a small business that falsely represented it was creditworthy, in part because it owns or intends to own exchange-traded stock."

SLUSA forbids large securities class actions "based upon … the purchase or sale of a covered security."

Justice Anthony Kennedy wrote a lengthy dissent, joined by Justice Samuel Alito. In the dissent, Justice Kennedy devoted significant attention to the fact that without the misrepresentations connecting the uncovered securities with covered securities, the plaintiffs would not have succumbed to the scheme. The dissent, described by the majority as exhibiting "hand wringing," maintained that the majority's approach was clearly contrary to Congress' efforts to prevent a flood of investor lawsuits based upon state court claims.

The majority did recognize the import of its ruling. The majority acknowledged its narrow construction of SLUSA, and, in turn, its potentially significant impact on the ability of plaintiffs to rely on state law in filing their class actions. The majority rejected, however, the dissent's view that the decision was somehow harming federal enforcement of securities laws and encouraging endless investor litigation.

It is clear that this ruling will allow more lawsuits, not just against corporations and directors and officers, but also against those involved as advisers, such as the law firms and brokers sued in these cases. The repercussions, then, will be felt by insurance companies providing coverage for these types of claims.

Jay Shapiro, partner and co-chair of the white-collar defense, investigations and corporate compliance group at **White & Williams** in New York, has more than 30 years of experience as a litigator. He represents clients in fraud-related litigation and investigations, criminal and regulatory enforcement, insurance fraud, and resolving trademark and copyright matters. He is a former professor at New York Law School and the author of numerous publications involving criminal law and trial practice.