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SOUTHERN DISTRICT CIVIL PRACTICE ROUNDUP

Expert Analysis

SLUSA's 'In Connection With' Rule: How Close Is Close Enough?

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The dual pillars of the Private Securities Litigation Reform Act of 1995[1] (PSLRA) and the Securities Litigation Uniform Standards Act[2] (SLUSA) create a deliberate obstacle course for securities fraud class action plaintiffs. The PSLRA imposes strict pleading requirements for claims brought under the federal securities laws, and SLUSA prevents class action plaintiffs from circumventing those requirements by styling their claims under state or common law to take advantage of more lenient pleading standards.

Predictably, plaintiffs press for a narrow reading of SLUSA and try to plead their claims as remotely as possible from the purchase or sale of a covered security that would bring their claims within SLUSA's ambit of preclusion. Defendants, by contrast, argue for a broader reading of the statute that sweeps within its protective scope claims that involve securities losses regardless of how such claims are literally pled. A number of cases from the U.S. District Court for the Southern District of New York, including actions brought by plaintiffs who lost money as a result of the Bernard Madoff fraud, have opened a new-front in the battle over SLUSA's reach. At least for now, these cases have resulted in a split in authority on the question of whether investors in funds which themselves invest either directly, or indirectly, in covered securities, may avoid the obstacles posed by SLUSA and ultimately by the PSLRA.

Statutory Framework

SLUSA provides that "[n]o covered class action based on the statutory or common law of any State…may be maintained in any State or Federal court by any private party alleging an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security."[3] The statute requires dismissal of "(1) [] a 'covered' class action (2) based on state statutory or common law that (3) alleges that defendants made a 'misrepresentation or omission of a material fact' or 'used or employed any manipulative device or contrivance in connection with the purchase or sale' (4) of a covered security."[4] Despite its relative brevity, SLUSA has given rise to substantial litigation over its intended scope, including battles over the nature of claims asserted, and the definition of a "covered" class action[5] and a "covered" security. Recent litigation in the U.S. Court of Appeals for the Second Circuit and district courts within the circuit has focused on the "in connection with" language of the third factor—requiring an allegation of an untrue statement or omission "in connection with" the purchase or sale of a covered security.

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The Requirement

Issue regarding the breadth of this requirement was originally joined in the Southern District of New York in a pair of decisions—*Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC.*[6] and *Barron v. Igolnikov*[7]—where Judge Shira A. Scheindlin and Judge Thomas P. Griesa, respectively, reached opposite conclusions regarding the statute's reach where the defendant was an intermediary between the plaintiff and the party ultimately transacting in covered securities.

In *Pension Committee*, plaintiffs, purchasers of shares in hedge funds which allegedly overvalued securities in their portfolios, asserted state and federal claims against, inter alia, the funds' administrator alleging it had prepared and distributed materially false monthly statements regarding the funds' performance and value and had failed to alert investors after learning of the overvaluation. *Barron* similarly involved a class action seeking to hold an asset management company, its parent company and several officers and directors liable for losses incurred as a result of indirect investments it made in "feeder funds" which ultimately invested with Bernard Madoff. Asserting common law claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, gross negligence, and unjust enrichment, plaintiffs alleged that despite discovering a number of "red flags" concerning Mr. Madoff in 2007, the defendants failed to warn their clients, continued to funnel money to the feeder funds (for which they collected fees from their investors) and provided inaccurate account statements to members of the class.

In *Pension Committee*, Judge Scheindlin held that because the untrue statements alleged by plaintiffs concerned the valuation of the hedge funds and the plaintiffs' shares in the funds, those misrepresentations were not made "in connection with" the purchase and sale of covered securities. Quoting Judge Charles S. Haight's 2007 decision in *LaSala v. Lloyds TSB Bank, PLC*, that the "conduct of a defendant is central to a SLUSA analysis and the mere allegation of misrepresentations somewhere in the complaint is not sufficient for SLUSA preemption," Judge Scheindlin concluded that only the administrator's alleged misstatements (and not those of the fund manager) were relevant to the SLUSA analysis.[8]

By contrast, in *Barron*, Judge Griesa found that SLUSA preclusion was justified even though plaintiffs did not directly purchase the covered securities, but purchased an interest in the defendant funds which in turn invested in covered securities through Mr. Madoff. He concluded that for SLUSA's bar to apply "it is only necessary to demonstrate deception in connection with the purchase or sale of a covered security, not the deception of plaintiff herself."

Judge Griesa grounded his broad interpretation of SLUSA's "in connection with" language on the Supreme Court's holding in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit* that to satisfy the "in connection with" requirement, "it is enough that the fraud alleged 'coincide' with a securities transaction—whether by plaintiff or someone else."[9] Under this approach, Judge Griesa concluded that even though plaintiffs themselves had bought shares in a fund, rather

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than in covered securities, the defendant funds' investment with Mr. Madoff, where Mr. Madoff claimed to be engaged in the trading of nationally listed securities, was sufficient to satisfy SLUSA's "in connection with" requirement.[10]

Judge Scheindlin adopted a narrower reading of *Dabit*, rejecting the argument by the *Pension Committee* defendants that any claim against them for misrepresentation of the funds' portfolio value was "necessarily dependent" upon the fund manager's misrepresentations to the administrator of the value of "covered securities" purportedly held by the funds. She found that the contention that claims against the administrator thus "coincide" with a securities transaction, "stretches the statute beyond its plain meaning." Reasoning that the Supreme Court in *Dabit* had addressed only the narrow issue of whether SLUSA applied to claims by holders of securities in addition to those by purchasers and sellers, Judge Scheindlin concluded that there was no basis on which to apply *Dabit* to statements made concerning "*uncovered hedge funds*—even when a portion of the assets in those funds included covered securities."[11]

Shortly after the decisions in *Pension Committee* and *Barron*, the Second Circuit considered SLUSA's "in connection with" requirement, in a slightly different context, in *Romano v. Kazacos*.[12] In that consolidated action, former employees of Xerox and Kodak alleged that they had opted to elect lump-sum early retirement benefits based on representations (or more precisely alleged misrepresentations) by representatives of Morgan Stanley that the returns on those sums would be sufficient, if invested with Morgan Stanley, to support them in retirement. After those investments lost much of their value, plaintiffs brought class actions against Morgan Stanley and its employees in New York state court alleging state law claims.

Defendants removed those actions to federal court, and successfully sought dismissal of both cases under SLUSA. On appeal, the plaintiff-retirees argued that SLUSA did not apply because the challenged misrepresentations were not alleged to have been made "in connection with" the purchase or sale of a covered security, but related instead to retirement and general financial advice that is "divorceable" from defendants' ultimate purchase of securities. Observing that courts may look beyond the allegations in the complaint to resolve questions of subject matter jurisdiction, the Second Circuit found that the account statements introduced by the appellants established that "the euphemistic 'investments' referred to throughout the amended complaints were, in fact, 'covered securities,'" within the meaning of the statute.

Turning to the "more difficult" question of whether the "in connection with" requirement had been met, the *Romano* court concluded that there was sufficient "connectivity" between the alleged misrepresentation and the purchase or sale of a covered security to satisfy SLUSA. The court relied on the Supreme Court's holding in *Dabit* that it is enough that the fraud alleged "coincide" with a securities transaction, concluding that the misrepresentations and omissions alleged by appellants "induced" the securities transactions at issue, and that the claims asserted "necessarily involve[d]" and "necessarily rest[ed] on" those transactions.[13] The panel rejected appellants' attempts to avoid SLUSA by characterizing their damages as "employment" damages and their claims as "garden variety" common law claims unrelated to the value of a particular security and exclusively concerned with financial planning, retirement and tax advice. It also noted that the lapse in time of up to eighteen months between the challenged representations and the securities investments complicated its analysis, but did not defeat the "in connection with" requirement. "[A]t the end of the day, this is a case where defendants' alleged misrepresentations induced appellants to retire early, receive lump sum benefits, and invest their retirement savings with defendants, where the savings were used to purchase covered securities.... Because both the misconduct complained of, and the harm incurred, rests on and arises from securities transactions, SLUSA applies."[14]

> Recent litigation has focused on the "in connection with" language—requiring an allegation of an untrue statement or omission "in connection with" the purchase or sale of a covered security.

Although the Second Circuit's ruling in *Romano*, did not address the precise question in *Barron* and *Pension Committee* of whether SLUSA preclusion applies to class claims by investors in funds which in turn invest directly or indirectly in covered securities, its observation that "[t]he 'coincide' requirement is broad in scope,"[15] would seem to support the position taken by Judge Griesa in *Barron* that SLUSA precludes such claims. Nevertheless, the most recent Southern District decision on this issue, by Judge Victor Marrero in *Anwar v. Fairfield Greenwich Ltd.*,[16] "follows the path struck in [Judge Scheindlin's decision] in *Pension Committee*" and holds that SLUSA does not apply to such claims.[17]

In *Anwar*, Judge Marrero refused to dismiss state law claims brought on behalf of investors in four Fairfield Greenwich funds, which in turn invested heavily in Madoff funds. Plaintiffs sued various Fairfield Greenwich entities and individuals, alleging violations of federal securities law and common law tort, breach of contract, and quasi-contract causes of action. Arguing, in essence, that the defendants should have known of Mr. Madoff's fraud, plaintiffs identified three "strands" of misrepresentations set forth in marketing materials and periodic updates regarding fund performance: 1) that plaintiffs' investments were invested by Mr. Madoff in a "split-strike conversion" strategy; 2) that Mr. Madoff's strategy resulted in substantial, consistent returns; and 3) that Fairfield Greenwich had performed extensive due diligence on Mr. Madoff and had full transparency to all of Mr. Madoff's operations.

In response to defendants' motion to dismiss on SLUSA preclusion grounds, plaintiffs asserted that their investments in the funds were not "covered" securities and that any purported purchases by Mr. Madoff were too removed from the plaintiffs' fund investments to "activate SLUSA's preclusive powers." Judge Marrero agreed with the plaintiffs, holding that the "multiple layers of separation between whatever phantom securities Mr. Madoff purported to be purchasing and the financial interests Plaintiffs actually purchased" did not satisfy the "in connection with" requirement.

He observed that "[t]hough the Court must broadly construe SLUSA's 'in connection with' phrasing, stretching SLUSA to cover this chain of investment—from Plaintiffs' initial investment in the Funds, the Funds' reinvestment with Mr. Madoff, Mr. Madoff's supposed purchases of covered securities, to Mr. Madoff's sale of those securities and purchases of Treasury bills—snaps even the most flexible rubber band."[18] Noting that plaintiffs had stated federal securities law claims against many of the defendants, in addition to the state law claims at issue in the SLUSA preclusion dispute, the Court found that SLUSA's policy objectives were not implicated and denied defendants' motion to dismiss based on SLUSA.[19]

Although *Romano* appears not to have resolved the conflict over SLUSA's application in this context,[20] the Second Circuit will have an opportunity to weigh in on this precise issue when it considers plaintiffs' appeal of Judge Griesa's decision in *Barron v. Igolnikov*.[21]

1. 15 U.S.C. §§77z-1, 78u-4.
2. 15 U.S.C. §§77p(b), 78bb(f).
3. 15 U.S.C. §77p(b)(1).
4. *Romano v. Kazacos*, 609 F.3d 512, 518 (2d Cir. 2010) (internal citations omitted); *Barron v. Igolnikov*, 2010 WL 882890, at 4 (S.D.N.Y. March 10, 2010).
5. See Edward M. Spiro, "Class Action Litigation Reform Update," New York Law Journal (April 5, 2007).
6. 2010 WL 546964 (S.D.N.Y. Feb. 16, 2010).
7. 2010 WL 882890 (S.D.N.Y. March 10, 2010).
8. 2010 WL 546964, at 2 (quoting *LaSala v. Lloyds TSB Bank, PLC*, 514 F. Supp. 2d 447, 472 (S.D.N.Y. 2007) (internal alterations and quotations omitted)).
9. 547 U.S. 71, 85-86 (2006).
10. 2010 WL 882980, at 5.
11. 2010 WL 546964, at 2 (emphasis in original). It is interesting to note that Judge Scheindlin rejected defendants' earlier argument (made before the Supreme Court's decision in *Morrison v. Nat'l Australia Bank*, 130 S.Ct. 2869 (2010)), that the federal securities laws did not apply to plaintiffs' foreign purchases of the funds. She held that the fund manager's purchase of listed securities was among the "conduct that directly caused the harm" for the purposes of determining subject matter jurisdiction. Id. at 3, n.31 (citing *Pension Committee of the University of Montreal Pension Plan v. Bank of America Securities, LLC*, 592 F. Supp. 2d 608, 626-27 (S.D.N.Y. 2009)).
12. 609 F.3d 512 (2d Cir. 2010).
13. Id. at 522 (citing earlier Second Circuit decisions construing the "coincide" test set forth in *SEC v. Zanford*, 535 U.S. 813 (2002), and §10(b)'s "in connection with" requirement).
14. Id. at 524.
15. Id. at 521.
16. __F. Supp. 2d__, 2010 WL 3341636 (S.D.N.Y. Aug. 18, 2010). One of the authors represents two individual defendants in this action.
17. In *Anwar*, Judge Marrero only briefly makes reference to the Second Circuit's decision in *Romano*, citing that case for: 1) the proposition that a court can look beyond the pleadings to the "realities underlying the claims" when considering SLUSA's application and 2) to note that the "coincide" requirement is broad in scope. 2010 WL 3341636, at 13.
18. Id.
19. Defendants sought leave to file an interlocutory appeal on a number of issues, including the applicability of SLUSA, which Judge Marrero denied in a Decision and Order dated Sept. 13, 2010.
20. Two other Madoff-related cases from the District of Connecticut contribute to the split within the Circuit. In both cases, Judge Peter C. Dorsey applied SLUSA to preclude class action plaintiffs' state law claims against banks which had invested their retirement funds in Madoff feeder funds. See *Backus v. Connecticut Community Bank, N.A.*, 2009 WL 5184360 (D. Conn. Dec. 23, 2009); *Levinson v. PSCC Services Inc.*, 2009 WL 5184363 (D. Conn. Dec. 23, 2009).
21. No. 10-1387-cv.