IV. SLUSA Preclusion of State Law Investor Class Actions

A. Introduction

In February 2014, the Supreme Court of the United States decided *Chadbourne & Parke LLP v. Troice*.[1] The Court provided a victory for investors, holding that the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") does not preclude state-law-based securities fraud class actions where the plaintiff investor himself did not buy securities covered by the law.[2] *Troice* limited the scope of SLUSA, and broadened opportunities for plaintiffs seeking recovery on state law securities fraud claims.[3] Justice Kennedy, joined in his dissent by Justice Alito, argued that the majority opinion in *Troice* "narrows and constricts essential protection for our national securities markets" and undermines the objectives of SLUSA.[4] The decision also raised concern among secondary actors, including lawyers and accountants, worried that they could now be liable in state court, without the protections of SLUSA and the Private Securities Litigation Reform Act ("PSLRA").[5] In July 2014, the First Circuit weighed in, holding that the misrepresentations at issue in the suit were not made "in connection with" transactions in covered securities and therefore SLUSA did not preclude the plaintiff's state securities fraud claims.[6]

This Article describes the purpose of the PSLRA and SLUSA, analyzes the First Circuit's decision in *Hidalgo-Velez*, and discusses future implications of *Troice*. Part B provides a description of the PSLRA and SLUSA. Part C analyzes the *Troice* decision and Justice Kennedy's dissent. Part D assesses the *Hidalgo-Velez* decision in the context of *Troice*. Finally, Part E discusses the implications of the *Troice* and *Hidalgo-Velez* decisions in the context of Justice Kennedy's *Troice* dissent.

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1 134 S. Ct. 1058 (2014).
2 Thao Do & James Walker, 'Troice' *Has Important Risk Management Implications*, N.Y. L.J., July 31, 2014, at 5.
3 *Id*.
4 *Troice*, 134 S. Ct. at 1073–74 (Kennedy, J., dissenting).
5 Do & Walker, *supra* note 2.
6 Hidalgo-Velez v. San Juan Asset Mgmt., Inc., 758 F.3d 98, 108 (1st Cir. 2014).

B. The Private Securities Litigation Reform Act and the Securities Litigation Uniform Standards Act

The Securities Exchange Act of 1934 was enacted in the wake of the 1929 stock market crash, and forbids "the use of any manipulative or deceptive devices or contrivances 'in connection with the purchase or sale of any security registered on a national securities exchange.'"[7] Section 10(b) of the Securities Exchange Act provides a private right of action, allowing injured persons to sue for damages suffered through a violation of the Act.[8] In an effort to stem the tide of meritless class actions alleging fraud in the sale of securities, Congress enacted the PSLRA in 1995 to "protect investors, issuers, and all who are associated with [the] capital markets from abusive securities litigation."[9] The PSLRA narrowed the scope of the private right of action available under Section 10(b) by: (1) imposing higher pleadings standards on plaintiffs, (2) permitting defendants to "obtain automatic stays of discovery," and (3) "limit[ing] recoverable damages and attorney's fees."[10]

The PSLRA did not spell the end of abusive securities fraud litigation.[11] Typically, pleading and proof requirements are lower under state laws than under federal laws, and secondary actors, protected under federal law, may be potential defendants under several state statutes.[12] Plaintiffs began bringing their securities fraud claims under state law to avoid the PLSRA's higher substantive and procedural requirements.[13] In 1998, Congress passed SLUSA "[i]n an effort to close this loophole."[14] SLUSA provides:

> No covered class action based upon the statutory or common law of any State or subdivision therefor may be maintained in any State or Federal court by any

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[7] *Id*. at 103–04 (quoting Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2012)).
[8] *Troice*, 134 S. Ct. at 1063.
[9] H.R. REP. NO. 104–369, at 32 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 679, 731; *see also* Erin Brady, *Determining the Proper Pleading Standard Under the Private Securities Litigation Reform Act of 1995 After* In re Silicon Graphics, 28 PEPP. L. REV. 471, 477 (2001).
[10] *Troice*, 134 S. Ct. at 1063.
[11] *Hidalgo-Velez*, 758 F.3d at 104.
[12] Do & Walker, *supra* note 2.
[13] *See Hidalgo-Velez*, 758 F.3d at 104.
[14] *Id.*

> 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.[15]

Under SLUSA, a "covered class action" includes a class action with more than fifty joined or prospective class members.[16] SLUSA does not apply to actions "brought on behalf of a State" or "based on the law 'of the State in which the issuer is incorporated.'"[17] SLUSA precludes "state-law claims involving nationally traded securities."[18] Alongside the Securities Exchange Act of 1934 and the PSLRA, SLUSA was enacted to end abusive and meritless class action securities litigation.[19]

C. *Chadbourne & Parke LLP v. Troice*

The Supreme Court addressed the "in connection with" language of SLUSA head-on in *Troice*.[20] The case arose out of a multibillion dollar Ponzi scheme led by Allen Stanford.[21] The plaintiffs purchased certificates of deposit in the Stanford Investment Bank, believing they would be used to purchase SLUSA covered securities.[22] Stanford instead used the money to repay old investors and to finance other ventures and "an elaborate lifestyle."[23] The Supreme Court granted certiorari to determine whether the plaintiffs' Louisiana state law securities fraud claims were precluded by SLUSA.[24]

In a 7-2 decision, the Supreme Court held 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

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[15] Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. § 78bb(f)(1) (2012) (emphasis added).
[16] Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1064 (2014).
[17] *Id.* at 1064 (quoting Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. § 78bb(f)(3) (2012)).
[18] *Id*. at 1074 (Kennedy, J., dissenting).
[19] *Id.*
[20] *Id.* at 1060 (majority opinion).
[21] *Id.* at 1064.
[22] *Id.*
[23] *Id.*
[24] *Id.* at 1065.

to sell a 'covered security.'"[25] Finding no indication in SLUSA that Congress intended the Act to be interpreted to "protect persons whose connection with the statutorily defined securities is more remote," the Court held that SLUSA did not apply to the plaintiffs' claims.[26] In so doing, the Court distinguished earlier decisions where it had called for a "broad interpretation" of the "in connection with" language, explaining that it was not departing from earlier case law, but rather applying SLUSA to the particular case of a misrepresentation that did not lead anyone other than the fraudster to buy or sell covered securities.[27]

Justice Kennedy wrote a dissenting opinion, which Justice Alito joined.[28] They predicted that the narrowing of SLUSA would lead to "a lessened confidence in the market, a force for instability that should otherwise be countered by the proper interpretation of federal securities laws and regulations."[29] The dissenters suggested that the market "as a whole" would suffer if frauds like the one in *Troice* were not covered by SLUSA.[30] Arguing that the factual situation in *Troice* was simply a more sophisticated version of the simple frauds implicated in the earlier cases the Court distinguished, the dissenters argued that "a broad construction" of the "in connection with" language would better regulate the national securities market, in line with the purposes of SLUSA.[31] Kennedy accused the Court of introducing confusion into the securities law, and of "excis[ing] the phrase 'in connection with' from the Act."[32]

The dissent characterized Congress's primary purpose in passing SLUSA as (1) precluding state law securities claims to protect

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[25] *Id.* at 1066.
[26] *Id.* at 1067–68 ("Not only language but also purpose suggests a statutory focus upon transactions involving the statutorily relevant securities.").
[27] Peter Isajiw, *Secondary Actors in Securities Transactions Beware: The Supreme Court May Have Aided and Abetted the Prospect of Increased State Court Litigation*, LAW.COM (April 18, 2014), http://www.law.com/sites/peterisajiw/2014/04/18/secondary-actors-in-securities-transactions-beware-the-supreme-court-may-have-aided-and-abetted-the-prospect-of-increased-state-court-litigation/?slreturn=20140829114800, *archived at* http://perma.cc/DQ56-7R2V; *see also* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 85 (2006) (expounding a broad construction of the "in connection with" language).
[28] *Troice*, 134 S. Ct. at 1072 (Kennedy, J., dissenting).
[29] *Id.* at 1073.
[30] *Id.* at 1078–79.
[31] *Id.* at 1075.
[32] *Id.* at 1081.

secondary actors from abusive class actions, and (2) "ensur[ing] robust federal regulation of the national securities markets."[33] Justice Kennedy cautioned that the decision would "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."[34] He criticized the majority's narrow construction of the "in connection with" language as preventing the "efficient and effective" federal regulation of securities.[35]

D. *Hidalgo-Velez v. San Juan Asset Management, Inc.*

In July 2014, the First Circuit addressed *Troice*'s interpretation of SLUSA.[36] In *Hidalgo-Velez v. San Juan Asset Management, Inc.*, the plaintiffs invested in the Puerto Rico & Global Income Target Maturity Fund (the "Fund").[37] The Fund advertised that it would invest at least 75% of its assets in notes with an "equally weighted exposure to both European and North American investment grade corporate bond indices," and "no more than 25% of its assets in securities issued by a single issuer."[38] The Fund subsequently invested more than 75% of its assets in notes sold by Lehman Brothers.[39] The notes lost most of their value during the subprime mortgage collapse in 2008, and the Fund was forced into liquidation.[40] The plaintiffs filed a putative class action in Puerto Rico state court alleging that the Fund did not comply with the promised investment policies, thereby violating Puerto Rican law.[41] The defendants removed the action to federal district court under

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[33] *Id.* at 1074.
[34] *Id.*
[35] *Id.* at 1075.
[36] *See generally* Hidalgo-Velez v. San Juan Asset Mgmt., Inc., 758 F.3d 98 (1st Cir. 2014).
[37] *Id.* at 102.
[38] *Id.*
[39] *Id.*
[40] Brett Goncher, *1st Circuit Revives State Law Fraud Suit Over Puerto Rican Investment Fund*, WESTLAW SEC. ENFORCEMENT & LITIG. DAILY BRIEFING, July 15, 2014, *available at* 2014 WL 3397824.
[41] *See Hidalgo-Velez*, 758 F.3d at 102.

SLUSA, and moved to dismiss based on SLUSA preclusion.[42] The district court granted the defendants' motion to dismiss.[43]

Describing SLUSA as "a spare but sweeping statute," the First Circuit considered its application in the wake of the "new light" shed on it by the Supreme Court in *Troice.*[44] The *Troice* decision, the First Circuit said, "broke new ground in illuminating the contours of the 'in connection with' requirement."[45] Applying the *Troice* holding, the First Circuit held that the "connection between the misrepresentations alleged and any covered securities in the Fund's portfolio [was] too tangential to justify bringing SLUSA into play."[46] While the Fund's advertisements did suggest that the Fund might purchase covered securities, the transactions carried out by the plaintiffs were exclusively in uncovered securities.[47] Therefore, the First Circuit held that SLUSA preclusion did not apply, because "*Troice* teaches that a misrepresentation in connection with the purchase of an uncovered security, by itself, is insufficient to bring a claim within SLUSA's grasp."[48]

The defendants argued that the Fund was set up as a "feeder fund."[49] In so doing, they attempted to analogize their case to *In re Herald*, which held that SLUSA preclusion applied to state law securities fraud claims arising out of Bernie Madoff's legendary fraud.[50] Feeder fund cases are those in which "the plaintiffs invested in funds that, directly or indirectly, acquired or purported to acquire covered securities."[51] The First Circuit distinguished the feeder fund cases from the Allen Stanford fraud, based on the fact that the funds involved in the Madoff scheme "were marketed primarily as vehicles for exposure to covered securities," inducing the investors to "intend[] to take an ownership interest in covered securities."[52] In contrast, in *Hidalgo-Velez*, the plaintiff investors did not attempt to take an ownership interest in, or sell, covered securities, because they believed

[42] *Id.*
[43] *Id.* at 102–03.
[44] *Id.* at 103, 106.
[45] *Id.* at 106.
[46] *Id.* at 108.
[47] *See id.* at 107; Goncher, *supra* note 40.
[48] *Hidalgo-Velez*, 758 F.3d at 107.
[49] *Id.* at 107.
[50] *Id.*; *see also In re* Herald, 753 F.3d 110, 112–13 (2d Cir. 2014).
[51] *Hidalgo-Velez*, 758 F.3d at 107.
[52] *Id.*; *see also In re Herald*, 753 F.3d at 113.

the Fund—pursuant to the Fund's advertisements—was going to purchase uncovered securities.[53] Therefore, the investors' relationship with any covered securities was "too attenuated" for SLUSA preclusion to apply.[54]

The First Circuit also presented a series of questions that courts should consider when determining whether an alleged fraud falls under SLUSA.[55] In determining "whether and to what extent the plaintiffs sought to take an ownership interest in covered securities," courts should consider: (1) what the fund represents its "primary purpose" to be, (2) whether the "promised mix of investments" is comprised of covered securities, and (3) the "nature, subject, and scope of the alleged misrepresentation."[56] Finally, the First Circuit noted that because "*only* . . . those who do not sell or participate in selling securities traded on U.S. national exchanges" can circumvent SLUSA preclusion, SLUSA still retains its punch.[57]

E. The Implications of *Hidalgo-Velez* and the *Troice* Dissent

Hidalgo-Velez faithfully applies the *Troice* holding.[58] With little deviation from the Supreme Court's *Troice* analysis, the First Circuit characterizes any tension between the Court's previous analysis of the "in connection with" language and the current, narrow interpretation as playing out on a fact-specific spectrum.[59] Cases like *In re Herald* involve the direct intention of the plaintiff investor to benefit from the purchase or sale of covered securities, and therefore SLUSA preclusion applies.[60] *Troice* and *Hidalgo-Velez* are distinguished by the tangential connection between the misrepresentations of the fraudster and the covered securities in the Fund's portfolio.[61]

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[53] *Hidalgo-Velez*, 758 F.3d at 108.
[54] *Id.*
[55] *See id.* at 108–09.
[56] *Id.* at 108.
[57] *Id.* at 108–09 (quoting Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1068 (2014)).
[58] *See* Cara Salvatore, *1st Circ. Cites Chadbourne Ruling in Remand of Fraud Suit,* LAW360 (July 10, 2014, 9:46 PM), http://www.law360.com/articles/556301/1st-circ-cites-chadbourne-ruling-in-remand-of-fraud-suit.
[59] *See Hidalgo-Velez*, 758 F.3d at 108.
[60] *Id.*; *see also In re* Herald, 753 F.3d 110, 113 (2d Cir. 2014).
[61] *See Hidalgo-Velez*, 758 F.3d at 108.

The concerns that Kennedy expressed in his *Troice* dissent, however, remain unresolved. The narrow interpretation of "in connection with" raises questions about liability among secondary actors in securities transactions.[62] Kennedy worried that the *Troice* holding would result in large numbers of secondary actors being drawn into meritless or abusive class action lawsuits in state court.[63] SLUSA provides protection for lawyers, accountants, and investment advisors, shielding them from state law liability and providing "the stability that results from a national securities market regulated by federal law."[64] If *Troice* and *Hidalgo-Velez* truly do limit the scope of SLUSA, those secondary actors may be vulnerable to an increase in state-law securities fraud claims.[65] While the Second Circuit's decision in *In re Herald* demonstrates that SLUSA still has teeth, secondary actors do operate in a less protected legal landscape following *Troice* and *Hidalgo-Velez*.[66]

Finally, Kennedy worried that a narrow interpretation of the "in connection with" language would undermine "robust federal regulation of the national securities markets."[67] The *Troice* majority dismissed Kennedy's concerns as unfounded, arguing that allowing the state court action to proceed did not hinder federal regulation, as evident by the fact that the SEC had already brought an action against Stanford.[68] According to *Troice's* majority opinion, a narrower interpretation of SLUSA does not hamper the ability of federal regulatory authorities to enforce federal securities regulations.[69]

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[62] *See* Isajiw, *supra* note 27.
[63] *See* Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1074 (2014) (Kennedy, J., dissenting) ("Throughout the country, then, it 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.").
[64] *Id.*; *see also* Do & Walker, *supra* note 2.
[65] *See* Do & Walker, *supra* note 2.
[66] *Id.* ("Notwithstanding *Herald* . . . the First Circuit's holding in *Hidalgo-Velez* demonstrate[s] that secondary actors with deep pockets (such as law firms) should enhance risk management policies with respect to their clients.").
[67] *Troice*, 134 S. Ct. at 1074.
[68] *Troice*, 134 S. Ct. at 1069 (majority opinion).
[69] *Id.*

F. Conclusion

The First Circuit concluded that "SLUSA is strong medicine and should be dispensed only in compliance with Congress's statutory prescription."[70] This language seems to suggest that the federal courts are intent on moving away from a broad construction of SLUSA's preclusion provisions. Going forward, it is unclear if the continuum model proposed in *Hidalgo-Velez* will provide lower federal courts with the tools necessary to reconcile the protective purposes of SLUSA with the new, more narrow interpretation of SLUSA adopted in *Troice*.

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[70] Hidalgo-Velez v. San Juan Asset Mgmt., Inc., 758 F.3d 98, 109 (1st Cir. 2014).
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