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SECURITIES LITIGATION

Ruling Clarifies Preclusion Of State Court Fraud Actions

By
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Even though it is now more than a decade since Congress imposed stricter requirements on securities fraud actions in the federal courts, tension remains between those requirements and plaintiffs' efforts to sidestep them by bringing securities-related claims in the state courts. A recent U.S. Court of Appeals for the Second Circuit decision, *Romano v. Kazacos*,[1] addresses this tension.

Romano broadly interpreted the preclusion provision of the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which bars plaintiffs from filing certain state-law-based class actions in state courts where the claims involve securities transactions.[2] *Romano* upheld dismissal of claims premised solely on state law, and the decision will make it much harder to use the state courts for bringing class actions involving securities fraud.

State Law Claims

Romano succinctly tracked the evolution of the recent reforms for bringing securities fraud cases. In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA), which adopted numerous new requirements for federal court class actions asserting securities fraud, including more stringent pleading requirements.[3] But as *Romano* noted, "[a]fter the PSLRA's enactment, plaintiffs began circumventing its restrictions by filing federal securities fraud class actions in state court, where they could assert many of the same causes of action while avoiding the PSLRA's requirements, which apply in federal court."[4] Thus, "to curb these perceived, new abuses," in 1998 Congress passed SLUSA.[5]

SLUSA provides that a "covered class action" filed in state court based on state law, and alleging securities fraud involving a "covered security," is removable to federal court. Once there, the action is to be dismissed.[6] A "covered class action" is a lawsuit in which damages are sought on behalf of more than fifty persons; a "covered security" is a security traded nationally and listed on a regulated national exchange.[7]

> 'Romano' makes it yet more difficult for a plaintiff to go to state court to assert claims for a large class premised on state law in the overarching context of a securities transaction.

Significantly, the allegations of securities fraud—either misrepresentation or omission of a material fact, or manipulation or deception—must be "in connection with the purchase or sale" of the covered security.[8] In short, SLUSA bars a state court class action asserting state law claims for a 50-plus member class where the underlying fraud involves a transaction in a nationally-traded security.

The 'Romano' Case

Romano involved two consolidated appeals. Plaintiffs in one case were retirees of Xerox, and plaintiffs in the other were retirees of Kodak. The operative facts of both cases were the same.

Plaintiffs alleged that as longtime employees of their companies, they were eligible for certain retirement benefits. They consulted with retirement specialists at defendant Morgan Stanley, who gave plaintiffs, as alleged, "retirement but not investment advice."[9] As part of the consultations, the Morgan Stanley advisors provided calculations for assessing plaintiffs' finances in retirement and advised on taking early retirement based on receipt of retirement benefits. Plaintiffs claimed that in reliance on the advice, they decided to retire early and elected to receive lump sum retirement benefits. Some time after consulting with the advisors, plaintiffs invested their retirement payouts in various securities through Morgan Stanley. Subsequently, the value of their investment portfolios declined substantially, resulting in financial hardship.

Plaintiffs filed putative class actions against Morgan Stanley and the individual advisors in New York state court. They alleged state law claims for negligence, breach of fiduciary duty, negligent misrepresentation, breach of contract and violation of a New York statute proscribing unfair and deceptive trade practices. The complaints defined the putative classes as Xerox and Kodak employees who received similar retirement

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advice from Morgan Stanley. Each putative class was described as involving at least 100 class members.

Based on SLUSA, the defendants removed the cases to federal court (where they were consolidated) and then moved to dismiss. Plaintiffs moved for remand to state court. The District Court (Judge David G. Larimer of the Western District of New York) denied the remand motions, held that SLUSA preempted the cases, and dismissed them.

The Second Circuit's Opinion

The Second Circuit reviewed the lower court's rulings de novo. At the outset, the court highlighted the four requirements for SLUSA preclusion—that the state court action "(1) is 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."[10] The main issue in *Romano*—as will frequently be the key issue in most SLUSA preclusion situations—was whether the case involved misrepresentations or omissions "in connection with the purchase or sale of a covered security."

Plaintiffs, understandably, had crafted their pleadings to avoid SLUSA by not alleging federal claims, and they argued that they were free to do so under the "master of the complaint" rule. The Second Circuit rejected this contention, holding that a court can look beyond the face of a complaint to determine SLUSA preclusion. The court explained that a plaintiff is the master of his complaint where the "well-pleaded complaint" rule applies to determine federal question jurisdiction; however, a corollary is the "artful pleading" rule, which holds that a plaintiff cannot avoid removal by declining to plead necessary federal questions. Where this rule applies, "courts look beyond the face of an 'artfully pled' complaint to determine whether plaintiff has…plead[ed] state law claims that actually arise under federal law."[11]

In that situation, removal is proper even though no federal question appears on the face of the complaint. The Second Circuit held that the "artful pleading" rule applied because SLUSA was both a congressionally-mandated statute of preclusion and a statute authorizing removal of certain actions. Thus, the court could look beyond the limited allegations on the face of the complaints to determine whether, in fact, they alleged securities fraud in connection within the purchase or sale of a covered security. This ruling—permitting a more expansive consideration of a case—is important to how courts can decide whether SLUSA preclusion applies.[12]

As to the additional requirements for preclusion, the court readily determined that plaintiffs' complaints—which asserted that defendants had misrepresented or concealed facts about whether plaintiffs could afford to retire, the feasibility of taking early retirement, and the like—alleged misrepresentations and omissions of material fact. The court then considered the "more difficult question" of whether plaintiffs' complaints alleged that the misrepresentations and omissions occurred "in connection with the purchase or sale" of covered securities.[13]

The Second Circuit relied on *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*,[14] which considered this question in a different factual setting. *Dabit* (which was decided on certiorari to the Second Circuit) involved state-law-based "holder" claims which alleged that the plaintiff was wrongfully induced to own and hold securities whose prices had been manipulated (resulting in losses to plaintiff once accurate information about the securities was revealed). The Second Circuit in *Dabit* held that these claims fell outside SLUSA preclusion because the wrongdoing was not in connection with the purchase or sale of securities, but the Supreme Court reversed, holding that SLUSA preclusion applied.

Romano relied on the *Dabit* analysis of the "in connection with" requirement—that it is met where the alleged fraud "coincides" with a plaintiff's purchase or sale of covered securities. This "coincide" requirement is derived from the Supreme Court's prior interpretations of the "in connection with" language in Section 10(b) and Rule 10b-5.[15] The Second Circuit emphasized that while several circuits have described the "coincide" requirement a bit differently, it is "broad in scope." Amplifying its meaning, the court explained that the requirement is met where the misrepresentations and omissions at issue "induced" the securities transactions and where the claims in question "necessarily involve" or "rest on" those transactions.[16]

Plaintiffs offered several arguments why *Dabit* connectivity was not met. They asserted that they specifically pleaded that they were not bringing claims based on state or federal securities laws; that they made no allegations relating to defendants' investment of the retirement funds; and that, in essence, they pleaded "only 'garden variety' state [law] claims" that were unrelated to the value of any security and involved only financial and retirement planning advice, which supposedly was "divorceable from [plaintiffs'] ultimate purchase of securities."[17] Plaintiffs also argued that they sought employment damages, rather than damages related to investments made with defendants, so that their eventual purchases and sales of securities were too attenuated from the alleged wrongdoing to trigger SLUSA preclusion.

The Second Circuit rejected these contentions. It said that plaintiffs' arguments were misplaced because "the task of determining whether SLUSA applies is not limited simply to an examination of the relevant pleadings," and the statute could not be avoided "merely by consciously omitting references to securities or to the federal securities law."[18] Thus, SLUSA requires attention "to both the pleadings and the realities underlying the claims."[19]

Nonetheless, having opened the door to beyond-the-pleadings consideration, the court made no findings about the realities of the claims from extra-pleading materials. Instead, it focused on the pleadings. It identified numerous allegations relating to investment in securities, such as defendants' statements about receipt of future returns on retirement assets, the approach of investing lump sum portfolios for retirement purposes, and the like.

The court concluded that these allegations met SLUSA's "in connection with" requirement because plaintiffs had asserted that "defendants fraudulently induced [plaintiffs] to invest in securities with the expectation of achieving future returns that were not realized."[20] This conclusion was driven by the need, as required by the Supreme Court, to give the "in connection with" requirement a broad construction. The Second Circuit also rejected plaintiffs' contention that they sought only "employment damages," finding that the injury complained of resulted from the diminution in value of plaintiffs' investment accounts.

Finally, the court held that the passage of time—an 18-month gap from when defendants first advised plaintiffs to when investment in the securities occurred—did not defeat the "in connection with" requirement. While

noting that timing "does complicate the analysis," the court still found that "the lapse of any particular amount of time" would not necessarily be dispositive on the connection requirement.[21] It emphasized that *Dabit* "does not pivot on temporal limitations" and instead constructed "a flexible standard," not a technical or restrictive one, for determining whether SLUSA applies to a particular class action. The time lapse of the alleged fraud-to-investment in *Romano* was not determinative because "this was a string of events that were all intertwined."[22]

As the court then summed up its analysis: "[T]his is a case where defendants' alleged misrepresentations induced [plaintiffs] 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."[23] The Second Circuit thus affirmed.

Ramifications of 'Romano'

Romano makes it yet more difficult for a plaintiff to go to state court to assert claims for a large class premised on state law in the overarching context of a securities transaction. Indeed, by rejecting the "master of the complaint" rule in a SLUSA context, the Second Circuit unquestionably has made it very hard for a plaintiff to plead around the statutory preclusion effect. And the court pointedly authorized inquiry beyond the face of a complaint, thereby permitting flexible consideration of the surrounding circumstances to determine whether the asserted state law claims really arise under the federal securities laws.

The *Romano* court's broad interpretation of the "in connection with" requirement also raises the bar for avoiding SLUSA preclusion. A plaintiff asserting fraud in a securities context will be hard-pressed to show that the wrongdoing does not "coincide" with the purchase or sale of the securities. In particular, any facts that indicate inducement to invest, at least involving the defendant directly, will likely come within the connectivity requirement. Timing considerations are likewise to be viewed very flexibly; as a consequence, separating the underlying facts of supposed wrongdoing from investment-like facts will not necessarily carry the day for a plaintiff, because courts will look to the continuum of events to gauge whether a temporal separation matters for connectivity. Similarly, the courts will be expected to scrutinize a plaintiff's characterization of the sought-after damages to see whether the injury is really investment related or otherwise flows from a securities transaction.

All this adds up to a very difficult path for avoiding SLUSA preclusion. Of course, that does not mean that state law claims implicating securities transactions can never be maintained in a state court. SLUSA applies only to class actions brought on behalf of a 50-plus group, and so an aggrieved party can sue individually or as part of a class numbering 50 or less.[24] Additionally, particular factual circumstances, such as reinvestment of a plaintiff's funds, might lead to a conclusion that the actual investment is too attenuated from the improper conduct to come within the "in connection with" requirement, or perhaps did not involve misrepresentation concerning the purchase or sale of a "covered security."[25]

But the effect of *Romano* generally will be to drive plaintiffs who believe they have been defrauded as part of a securities transaction to assert securities law claims in federal court—where more rigorous standards for maintaining suit now apply. While only time will tell, *Romano* portends very infrequent resort to the state courts for bringing claims involving securities fraud.

1. 609 F.3d 512 (2d Cir. 2010) (Parker, J.).
2. See 15 U.S.C. §78bb(f)(1). SLUSA, Pub. L. No. 105-353, 112 Stat. 3227 (1998), amended both the Securities Exchange Act of 1934 and the Securities Act of 1933 in substantially the same ways. See Romano, 609 F.3d at 518 n.1. References here, as in Romano, are to only the Securities Exchange Act provisions. The Securities Act provisions are codified principally at 15 U.S.C. §77p.
3. 15 U.S.C. §§77z-1, 78u-4.
4. *Romano*, 609 F.3d at 517 (citations omitted).
5. Id. See SLUSA, Pub. L. No. 105-353, §2(5) (Congressional finding that "in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA], it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities").
6. 15 U.S.C. §78bb(f)(1) ("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 [securities fraud]…."); id. §78bb(f)(2) ("Any covered class action brought in any State court involving a covered security… shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to paragraph (1)").
7. Id. §78bb(f)(5)(B), (E). SLUSA's definition of "covered security" is pegged to standards set forth in the Securities Act, see *Romano*, 609 F.3d at 518, 520 n.3.
8. 15 U.S.C. §78bb(f)(1)(A), (B).
9. *Romano*, 609 F.3d at 515.
10. Id. at 518 (citing 15 U.S.C. §78bb(f)).
11. Id. at 519 (citation omitted).
12. Relatedly, the court held that it could consider materials outside the pleadings to ascertain whether "covered securities" were involved. The court explained that deciding removal and remand issues under SLUSA, which includes determination of whether "covered securities" are at issue, presents a question of subject matter jurisdiction—and where subject matter jurisdiction is contested, courts can look at extra-complaint materials. Id. at 520-21. The record included account statements establishing that plaintiffs had deposited their retirement benefits into Morgan Stanley accounts for which covered securities (e.g., mutual funds and listed securities) were purchased for plaintiffs. Id.
13. Id. at 521.
14. 547 U.S. 71 (2006).
15. *Romano*, 609 F.3d at 521 (citing *SEC v. Zandford*, 535 U.S. 813, 822 (2002); *United States v. O'Hagan*, 521 U.S. 642, 656 (1997)).
16. Id. at 521 & n.5, 522.
17. Id. at 522.
18. Id. at 523.
19. Id.
20. Id.
21. Id. at 524.
22. Id. (quotation marks and citation omitted).
23. Id.
24. See *Dabit*, 547 U.S. at 87; *Romano*, 609 F.3d at 519 n.2. Nonetheless, another significant obstacle may exist to pursuing fraud-related securities claims in New York state court. Cases hold that certain common law claims involving deception in connection with the sale of securities cannot be maintained by a private plaintiff because they are preempted under New York's blue sky law, the Martin Act (N.Y. Gen. Bus. Law Art. 23-A, §352, et seq. (McKinney 2010)), since the Martin Act vests exclusive jurisdiction over state law claims involving fraud in connection with securities transactions with the State Attorney General. See, e.g., *Castellano v. Young & Rubicam Inc.*, 257 F.3d 171, 190 (2d Cir. 2001); *Nanopierce Tech. Inc. v. Southridge Capital Mgmt. LLC*, 2003 WL 22052894, at 1-4 (S.D.N.Y. Sept. 2, 2003). But see *Anwar v. Fairfield Greenwich Ltd.*, 2010 WL 3022848 (S.D.N.Y. July 29, 2010) (rejecting prior case law and holding that Martin Act does not preempt common law claims).
25. See, e.g., *Anwar v. Fairfield Greenwich Ltd.*, 2010 WL 3341636, at 12-14 (S.D.N.Y. Aug. 18, 2010) (SLUSA preclusion rejected in class action brought against investment funds, related entities and professional service providers arising out of funds' investment in the Madoff Ponzi scheme; court found "in connection with" requirement not met because "[t]he allegations… present multiple layers of separation between whatever phantom securities Madoff purported to be purchasing and the financial interests Plaintiffs actually purchased"). Importantly, however, the *Anwar* court noted that SLUSA's application in the Madoff-feeder-fund context, where a plaintiff's ultimate investment with Madoff was through another investment entity, is an open question in the Second Circuit. See id. at 13 n.6. In concluding that SLUSA was not applicable in this context, the *Anwar* court followed *Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec. LLC*, 2010 WL 546964 (S.D.N.Y. Feb. 16, 2010), which held that investments in shares of hedge funds did not involve a "covered security" even though the hedge funds had invested in covered securities. See *Anwar*, 2010 WL 3341636, at 13 n.6.

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