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Justices OK Suits Against Law Firms in Ponzi Scheme

Goldstein & Russell's Thomas Goldstein
Photo: Diego M. Radzinschi / NLJ

Private investors burned in Allen Stanford's $7 billion Ponzi scheme can move ahead with their state-law class actions against two prominent law firms and insurance brokers, the U.S. Supreme Court ruled on Wednesday.

The federal Securities Litigation Uniform Standards Act of 1998 (SLUSA) does not bar the investors' claims against Chadbourne & Parke, Proskauer Rose and insurance broker Willis of Colorado for allegedly aiding and abetting Stanford's fraud, Justice Stephen Breyer wrote for a 7-2 majority.

The federal law forbids large securities class actions based on state law in which plaintiffs allege "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." In the three consolidated cases before the court—*Chadbourne & Parke v. Troice*, *Willis of Colorado v. Troice* and *Proskauer Rose v. Troice*—the question for the justices was how far that language reached: Did it extend beyond misrepresentations that are material to the purchase or sale of a covered security?

"In our view, the scope of this language does not extend further," Breyer wrote. "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 to sell a 'covered security.' "

The securities involved in the state-law class actions were not "covered securities" under SLUSA because they were not traded nationally or listed on a regulated national exchange.

In their state suits, the investor-plaintiffs claimed they were induced to purchase CDs, which are uncovered securities, based on false representations that the money paid for the CDs would be used to purchase highly lucrative assets. They alleged the defendants helped the bank and Stanford perpetrate the fraud or conceal it from regulators.

Breyer wrote that the federal law did not bar those class actions for several reasons:

First, the law focuses on transactions in covered securities, not in uncovered securities. There must be a material connection with a transaction in a covered security.

Second, a natural reading of the act's language supports that interpretation. "The phrase 'material fact in connection with the purchase or sale' suggests a connection that matters," Breyer wrote. "And for present purposes, a connection matters where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security, not to purchase or to sell an uncovered security, something about which the Act expresses no concern."

Additionally, case law supports the majority's interpretation, he said. "As far as we are aware, every securities case in which this Court has found a fraud to be 'in connection with' a purchase or sale of a security has involved victims who took, who tried to take, who divested themselves of, who tried to divest themselves of, or who maintained an ownership interest in financial instruments that fall within the relevant statutory definition. We have found no Court case involving a fraud 'in connection with' the purchase or sale of a statutorily defined security in which the victims did not fit one of these descriptions."

Justice Anthony Kennedy, joined by Justice Samuel Alito Jr., dissented, saying, "The Court's narrow interpretation of the Act's language will inhibit the [Securities and Exchange Commission] and litigants from using federal law to police frauds and abuses that undermine confidence in the national securities markets."

He warned that the decision "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."

However, Breyer countered, "When the fraudster peddles an uncovered security like the CDs here, the Federal Government will have the full scope of its usual powers to act. The only difference between our approach and that of the dissent, is that we also preserve the ability for investors to obtain relief under state laws when the fraud bears so remote a connection to the national securities market that no person actually believed he was taking an ownership position in that market."

Former solicitor general Paul Clement, now at Bancroft in Washington, argued for Willis and the law firms. Thomas Goldstein of Goldstein & Russell, also in Washington, represented the defrauded investors.

Reacting to the ruling, Goldstein said, "We're obviously glad that the Stanford victims will get their day in court against the people that they believe helped to make this massive fraud possible. The justices understood that Congress could not have intended to block a suit like this that doesn't involve the victims buying stocks. And they recognized that even the SEC had never used their theory in the case."

Charles Smith, a securities litigator at Skadden, Arps, Slate, Meagher & Flom, called the decision a "refinement" of the law, rather than a major change.

"Stanford's fraudulent certificates—the securities investors bought from him—were not 'covered securities' within the meaning of SLUSA, so the defendants could not use SLUSA to bar the state-law claims," Smith said. "That appears at first blush to be a relatively narrow holding, but is in tension with the court's prior broad reading of the 'in connection with' language of SLUSA in *Merrill Lynch v. Dabit."*

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