July 2019

The Ninth Circuit Fastens Some Guardrails to SLUSA's "In Connection" Requirement

By Peter Stone, Scott Carlton & Kiaura Clark

On July 5, 2019, the Ninth Circuit issued a decision in *Banks v. Northern Trust Corporation*, et al., No. 17-5625, addressing the scope of the Securities Litigation Uniform Standards Act of 1998 (SLUSA). Relying heavily on the Supreme Court's decision in *Chadbourne & Parke LLP v. Troice*, 571 U.S. 377 (2014), the Ninth Circuit held that SLUSA did not preclude the plaintiffs' claims under state law because the defendant's fraudulent conduct only had a "tangential relation to the securities transaction." The decision helps clarify the scope of federal preclusion under SLUSA, placing some far outer guardrails on the generally liberal application of the statute's "in connection" requirement.

The Purpose of SLUSA

In 1995, Congress sought to reduce vexatious securities litigation by enacting the Private Securities Litigation Reform Act (PSLRA). Among other statutory reforms, the PSLRA places heightened pleading standards on private plaintiffs filing claims under the federal securities laws. To avoid the heightened pleading standards, however, plaintiffs began filing their lawsuits in state courts under state statutory or common law.

Congress responded to this "federal flight" problem by enacting SLUSA. SLUSA provides that no private plaintiff can file a class action seeking to represent more than 50 persons in any court based on state law claims that are premised on a misrepresentation or manipulation "in connection with the purchase or sale of" a security covered by the Securities Act of 1933.

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006), the Supreme Court had its first opportunity to interpret the scope of the "in connection" requirement under SLUSA. Plaintiffs in *Dabit*, Merrill Lynch brokers, alleged state law claims for breach of fiduciary based on allegedly biased research and investment recommendations from Merrill Lynch that caused the brokers to hold the recommended securities. The Court held that SLUSA precluded the state law claims, offering a broad interpretation of the "in connection" requirement. The Court stated that the fraud must only "coincide" with the purchase or sale of a security to satisfy the "in connection" requirement. The Court expressed concern that a narrower reading of SLUSA would undercut the goal of preventing plaintiffs from evading the pleading strictures of the PSLRA.

Eight years later, in *Troice*, the Supreme Court again addressed SLUSA's "in connection" requirement. Plaintiffs in *Troice* alleged that defendants induced victims to purchase uncovered securities by misrepresenting that covered securities backstopped them. The Supreme Court held that SLUSA did not preclude the claims. In so doing, *Troice* made clear that it did not overturn *Dabit*; instead, the Supreme Court simply sought to clarify the scope of SLUSA's application, holding that SLUSA's preclusive impact does not "extend further than misrepresentations that are material to the purchase or sale of a covered security" and requires that "the misrepresentation makes a significant difference to someone's decision to purchase or sell a covered security."

The Ninth Circuit's Decision in *Banks*

Plaintiffs are the beneficiaries of an irrecoverable trust for which Northern Trust Company and Northern Trust Corporation ("Northern") acted as the trustee. As the trustee, Northern maintained the sole discretion on how to manage the trust's assets.

In December 2016, plaintiffs filed a putative class action against Northern, alleging that Northern violated fiduciary duties owed to plaintiffs when Northern purportedly invested the trust's assets in Northern's own affiliated portfolio rather than seeking superior investments outside Northern's financial umbrella. Plaintiffs also alleged that Northern committed elder abuse and violated California's unfair competition laws. The district court dismissed the putative class action, holding that claims are barred by SLUSA because the "imprudent investments were in connection with the purchase or sale of covered securities and featured material misrepresentations or omissions."

The Ninth Circuit reversed. Although the court recognized that *Dabit* encouraged a broad interpretation of the "in connection" requirement, the court held that the requirement must not be read "so broadly that the connection between a defendant's conduct and the covered security becomes immaterial." The court relied on the Supreme Court's decision in *Troice*, which "stressed that 'the someone making that decision to purchase or sell must be a party other than the fraudster.'" "If the only party who decides to buy or sell a covered security as a result of a lie is the liar, that is not a 'connection' that matters." *Troice*, 571 U.S. at 388.

In *Banks*, plaintiffs made no investment decision and had no control over the purchase or sale of securities. Since *Troice* requires "a connection . . . where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security," the "in connection" requirement was not satisfied. *Id*. at 387. The Ninth Circuit held that Northern was alleged to be "both the buyer and the 'fraudster'; because the trustee can deceive only itself with any alleged misconduct, its misconduct does not require SLUSA preclusion." The court ultimately found that Northern's reading of *Dabit* would essentially "render *Troice* meaningless the way that *Game of Thrones* rendered the entire Night King storyline meaningless in its final season."

Banks' Impact on the Breadth of SLUSA Preclusion

The Ninth Circuit's decision in *Banks* places a common sense—but narrow—outer limitation on SLUSA's "in connection" requirement. *Troice* directs courts to focus on whether the fraud has a material difference in the purchase or sale of a covered security. In other words, someone must be induced into a securities transaction based on the fraud. Since Northern was both the entity making the decision and the accused fraudster, the Ninth Circuit held that Northern was obviously not induced into purchasing or selling covered securities as a result of the fraud.

It is difficult to envision many scenarios where a plaintiff would bring a fraud-related claim in connection with the purchase or sale of a covered security, but the defendant maintained the sole discretion to make the investment decision. The *Banks* decision thus may only result in a narrow limitation on the scope of the "in connection" requirement, with that limitation being unlikely to preclude SLUSA's application in the vast majority of claims brought by securities plaintiffs.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings lawyers:

Los Angeles

Scott Carlton
+1.213.683.6113
scottcarlton@paulhastings.com

Palo Alto

Peter Stone
+1.650.320.1843
peterstone@paulhastings.com