April 28, 2015

Second Circuit Issues Decision Establishing Comprehensive Framework for Adjudicating Preclusion Issues Under SLUSA

Last Thursday, the Second Circuit issued an important opinion interpreting the preclusion provisions of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[1] SLUSA bars plaintiffs from bringing class actions (or certain other forms of consolidated actions) asserting certain securities-related claims under state law. A primary purpose of SLUSA is to prevent plaintiffs from evading restrictions on securities-related class actions under federal law by reframing those class actions under state law. Among the most significant such restrictions under federal law are those contained in the Private Securities Litigation Reform Act of 1995.[2]

Identifying exactly what state-law class actions[3] involving securities are barred (or, to use the term adopted by the courts, "precluded") by SLUSA, however, has proven challenging. In last Thursday's decision, Judge Leval, writing for a unanimous panel of the Second Circuit in *In re Kingate Management Ltd. Litigation*, No. 11-1397-cv (2d Cir. Apr. 23, 2015), attempted to provide a comprehensive framework for the analysis of preclusion issues under SLUSA. Part I below summarizes that opinion; Part II discusses the opinion in greater detail; and Part III discusses some potential implications of the opinion for future litigation.

I. Summary

The Second Circuit's 69-page opinion in *Kingate* will be relevant to a broad range of issues under SLUSA. The following three holdings, however, appear to be at the core of *Kingate*.

1. SLUSA states that it precludes only certain state-law class actions related to "covered securities," which include securities traded on a national exchange and securities issued by mutual funds and other registered investment companies. *Kingate* held that the plaintiffs' attempt to invest indirectly in covered securities was sufficient to satisfy the "covered securities" requirement.

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1 Pub. L. No. 105-353, 112 Stat. 3227.

2 Pub. L. No. 104-67, 109 Stat. 737.

3 We use "class actions" to refer to the class actions and other forms of consolidated actions that fall within SLUSA's preclusion provisions. We use "untruthful conduct" to refer to the untrue statements, omissions, and manipulations that trigger preclusion under SLUSA.

2. SLUSA precludes only state-law class actions alleging (1) "an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security" or (2) certain manipulative and deceptive practices.[4] The text of SLUSA does not explicitly require that a precluded action allege an "untrue statement or omission" made by, or attributable to, the defendant. *Kingate* ruled, however, that SLUSA precludes only actions "accusing the defendant of complicity in the false conduct." (Op. 7.) The opinion sets forth a complex definition of "complicity" for this purpose, which may not fully track an intuitive understanding of the word.

3. *Kingate* held that SLUSA precludes claims only if an allegation of untruthful conduct forms the basis for the claim at issue. (Op. 39; *see id.* at 6, 27–29, 55–56.) A plaintiff may not try to obscure the real relationship between allegedly untruthful conduct and the plaintiff's claims through artful pleading, such as the artful characterization of "a claim of falsity as a breach of the contractual duty of fair dealing." (Op. 27, 55–56.) But SLUSA, as interpreted in *Kingate*, does not preclude a claim if any untruthful conduct alleged is merely "extraneous" or "irrelevant" to the complaint's theory of liability. (Op. 36, 38.)

II. The *Kingate* Opinion

1. **The *Kingate* Complaint.** *Kingate* concerned two foreign "feeder funds." The funds retained a management firm operated by Bernard Madoff as the custodian for the funds' assets. Mr. Madoff's firm, which was later revealed to be a Ponzi scheme, stole the fund's assets.

   The *Kingate* plaintiffs purported to bring a class action on behalf of substantially all investors in the feeder funds. Plaintiffs asserted claims under state law for fraud, negligence, breach of contract, breach of fiduciary duty, and a variety of other causes of action. (Op. 12.) The *Kingate* defendants included managers of the funds, auditors, a consultant to the funds, and the funds' administrator. (Op. 8.) According to plaintiffs, the *Kingate* defendants had failed to fulfill their obligations to evaluate and monitor Mr. Madoff's firm; had failed to determine the real value of the investments in the funds; and had falsely represented to plaintiffs and members of the putative class that defendants had fulfilled these obligations and made these determinations. (Op. 11.)

   The district court held that SLUSA precluded all of plaintiffs' claims.

2. **The *Kingate* Court's Rulings.** *Kingate* asked three basic questions about the applicability of SLUSA. First, had plaintiffs alleged untruthful conduct in connection with the purchase or sale of a "covered security," as is required for preclusion under SLUSA? Second, does SLUSA preclude

[4] 15 U.S.C. § 77p. SLUSA added this preclusion provision to the Securities Act of 1933. SLUSA also added a similarly worded preclusion provision to the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78bb.

claims only if the untruthful conduct alleged has some relationship to the relevant defendant, and if so, what relationship is required? Third, does SLUSA preclude claims only if the untruthful conduct alleged has some relationship to plaintiffs' claims and theories of liability, and if so, what relationship is required?

The "Covered Security" Requirement

Shares in the feeder funds at issue in *Kingate* were not covered securities. Investors in the funds believed, however, that the feeder funds, in turn, were investing in shares of common stock traded on national exchanges. Those shares of common stock *were* covered securities. According to the *Kingate* defendants, investors in the funds therefore attempted to acquire indirect interests in covered securities. This attempt, defendants contended, was sufficient to satisfy the "covered securities" requirement for SLUSA preclusion.

The *Kingate* court agreed with defendants, based on a similar holding in *In re Herald,* 753 F.3d 110 (2d Cir. 2014). *Kingate* therefore held that the "covered securities" requirement for SLUSA preclusion was satisfied. (Op. 35.)

The Required "Complicity" of the Defendant in the Untruthful Conduct

Kingate also ruled that SLUSA precludes a claim against a defendant only if the defendant was "complicit" in some alleged untruthful conduct. (Op. 7.) Under *Kingate*, a claim alleges "complicity" if the claim is "predicated on conduct by the defendant that is specified in SLUSA's operative provisions [i.e., SLUSA's basic preclusion provisions] referencing the anti-falsity proscriptions of [the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act")]." (Op. 46.) This somewhat Delphic passage refers to the fact that SLUSA's preclusion provisions are based in part on language from the Securities Act and the Exchange Act.

It is clear that if a defendant allegedly made a liability-creating untrue statement or omission, or allegedly engaged in a liability-creating manipulation, the "complicity" requirement is satisfied. *Kingate* stated that this is so whether or not the defendant acted with fraudulent intent. (Op. 60–61.) *Kingate* also held, based on the Second Circuit's prior decision in *In re Herald*, 730 F.3d 112 (2d Cir. 2013), that state-law claims for aiding and abetting allege "complicity." (Op. 61–62.) And as the Securities Act and the Exchange Act provide for control-person liability,[5] claims under state law that are analogous to federal control-person claims must also allege "complicity."

[5] *See* Securities Act § 15, 15 U.S.C. § 77o(a); Exchange Act § 20(a), 15 U.S.C. § 78t(a).

But beyond these propositions, analysis of "complicity" under *Kingate* becomes murkier. *Kingate* applied its definition of "complicity" to the claims before it only at a high level of generality, so that application does not fully illuminate what "complicity" means.

The Requirement That Untruthful Conduct Form the Basis for a Claim

SLUSA precludes certain state-law securities class actions "alleging" untruthful conduct. As *Kingate* recognized, SLUSA can be interpreted to mean that *any* allegation of untruthful conduct triggers preclusion, whether or not the allegation is relevant to the plaintiff's claims. *Kingate* rejected that interpretation. *Kingate* reasoned that allegations in complaints are sometimes "unrelated to the legal theory of the complaint." Allegations are sometimes included not for legal support, but "for the eyes of the press" or to "bias the court or jury against the adversary." (Op. 37–38.) *Kingate* therefore ruled that SLUSA preclusion applies only if the untruthful conduct alleged is "necessary to" plaintiffs' state-law theories of liability, or "forms the basis" for those theories (Op. 39), or the theories "depend on" (Op. 6; *see* Op. 55–56) such an allegation.

Determining whether an allegation forms part of the basis for a claim, for purposes of analysis under *Kingate*, will require meticulous analysis of each arguably precluded state-law claim, the theories of liability underlying each such claim, and the relationship between each such theory and each arguably relevant allegation of untruthful conduct. Defendant-by-defendant analysis within each theory is also likely to be required, both because of the "complicity" requirement noted above, and because the same theory of liability may implicate different allegations of untruthful conduct for different defendants.

Application of SLUSA to Plaintiffs' Claims

The Second Circuit, after offering general guidance on the application of these principles to the claims at issue in *Kingate*, remanded to the district court for more detailed claim-by-claim and defendant-by-defendant analysis.

III. Analysis

1. The parties to *Kingate* may seek review of the panel's decision through a petition for rehearing to the panel, a petition for rehearing en banc before all of the Second Circuit judges in regular active service, or a petition for certiorari to the United States Supreme Court. In any event, unless and until the Supreme Court addresses these issues, we would expect vigorous litigation in other circuits concerning whether to accept *Kingate*'s holdings concerning "complicity" and extraneous allegations.

2. *Kingate*'s reaffirmation of the Second Circuit's prior holding in *In re Herald* on the "covered securities" issue was unsurprising. That reaffirmation, however, reinforces a significant principle in the Second Circuit's SLUSA jurisprudence. SLUSA's "covered securities" requirement, those decisions establish, is satisfied by indirect interests in such securities. This issue has arisen frequently in recent years.

3. *Kingate* emphatically endorsed a widely accepted but crucial aspect of SLUSA jurisprudence. SLUSA preclusion does not depend on whether untruthful conduct is a formal element of a plaintiffs' state-law claims. (Op. 55.) SLUSA necessarily precludes a covered class action alleging state-law claims for which untruthful conduct is an element, but SLUSA preclusion sweeps substantially more broadly: a prohibited allegation offered in support of a claim is enough. And a plaintiff may not "evade SLUSA by camouflaging allegations that [trigger preclusion] in the guise of allegations that do not." (*Id.*) In other words, a court applying SLUSA will look to substance, even if a plaintiff has "artfully avoided using SLUSA's terms." (Op. 56.)

4. According to *Kingate*, the holdings in that decision concerning "complicity" and extraneous allegations are interpretations of the statutory word "alleging." But as *Kingate* acknowledged, the word "alleging" could also support a broader view of preclusion. (Op. 37–39.) The Second Circuit's primary arguments in support of these holdings appear to rely on that court's view of the history and purposes of SLUSA.

   The Second Circuit and the United States Supreme Court, however, have previously disagreed over whether the interpretation of SLUSA should emphasize history and purposes, on the one hand, or text, on the other. In *Dabit* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005), *vacated,* 547 U.S. 71 (2006), the Second Circuit adopted a comparatively narrow view of preclusion under SLUSA for reasons related primarily to the perceived statutory purposes. The Supreme Court rejected the Second Circuit's approach. The Supreme Court instead took a broader view of preclusion under SLUSA for reasons related primarily to the statutory text. 547 U.S. at 85–86. The issues presented in *Kingate* are different, but a similar dynamic between purpose-based and text-based interpretations of SLUSA could emerge.

5. *Kingate* left development of its "complicity" requirement to future case law. Allegations that a defendant aided and abetted untruthful conduct, or that a defendant is liable for untruthful conduct based on a state-law analogue to control-person liability, clearly allege "complicity." Claims under the laws of some states, however, can allege (or attempt to allege) that a defendant is liable for untruthful conduct by another on a wide range of additional theories, including successor liability, respondeat superior, principal/agent relationships, "conspiracy" theories, and theories derived from particular state statutes. Further litigation concerning whether some or all such theories allege "complicity," as defined in *Kingate*, is likely.

6. *Kingate* involved claims and allegations that attempted to "predicate liability on Defendants' breach of contractual, fiduciary, or tort-based duties owed to Plaintiffs, resulting in failure to detect the frauds of Madoff" and his firm. (Op. 14.) According to *Kingate*, SLUSA did not preclude allegations within this category that "do not requir[e] a showing of false conduct *by the named Defendants* of the sort specified in SLUSA." (Op. 62–63.) But if proof of such an allegation *would* require proof that the defendant engaged in untruthful conduct, SLUSA precluded the allegation. (Op. 13–14 nn. 6, 7.)

   Often a plaintiff sues a professional defendant on the theory that (i) the professional performed its job poorly, in breach of some contractual or tort-based duty, and (ii) this poor performance produced injury to plaintiffs because the professional made some representation to investors that was not true, or omitted to disclose to investors some fact that the professional failed to discover. For example, a plaintiff might allege that an auditor performed a poor job on an audit, and that as a result its audit opinion was untrue or misleading. Under *Kingate*, if a defendant's supposed breach of duty allegedly produces injury *through the defendant's untruthful conduct*, logically any claim supported by explicit or implicit allegations of untruthful conduct should be precluded. And that should be true whether or not the defendant allegedly acted with fraudulent intent. (*See* Op. 60–61.)

7. *Kingate*'s distinction between extraneous allegations and allegations that form the basis for a claim is also likely to be the subject of future litigation. *Kingate* accurately notes that complaints often contain irrelevant allegations. Rule 8(a) of the Federal Rules of Civil Procedure, however, states that a complaint should contain jurisdictional allegations, a demand for relief, and "a short and plain statement of the claim showing that the pleader is entitled to relief."

   One might therefore question whether SLUSA should be limited so as to make allowance for plaintiffs that improperly include extraneous material in their complaint. In applying *Kingate*'s interpretation of SLUSA, a district court could reasonably require a plaintiff to remove extraneous allegations from the complaint. The district court could then deem the remaining allegations to form the basis of the claims for purposes of SLUSA.

8. After *Kingate*, defendants will need to draft motions to dismiss under SLUSA quite differently—especially motions addressed to district courts in the Second Circuit. Motions will need to be attentive to whether the moving defendant was allegedly "complicit" in untruthful conduct and whether any untruthful conduct alleged forms the basis for particular state-law claims. This analysis will be considerably more complex and detailed than the analysis that has previously characterized most litigation of SLUSA issues.

9. Courts ordinarily apply SLUSA at the outset of a case on motions addressed to the face of the complaint. SLUSA, however, provides that no "covered class action . . . may be *maintained* . . .

alleging" untruthful conduct. 15 U.S.C. §§ 77p(b), 78bb(f)(1) (emphasis added). Even if an allegation of untruthful conduct in a complaint is deemed extraneous under *Kingate*, any effort by the plaintiff to prove that allegation during the course of the litigation should entitle the defendant to renew its arguments for preclusion under SLUSA.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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