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*The \$7 Billion Stanford Ponzi Scheme: Class Litigation Against  
Third-Party Actors Under the Securities Litigation Uniform  
Standards Act*

**Linda S. Mullenix**

*University of Texas School of Law*

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## The \$7 Billion Stanford Ponzi Scheme: Class Litigation Against Third-Party Actors Under the Securities Litigation Uniform Standards Act

### CASE AT A GLANCE

Investors in the highly publicized \$7 billion financial Ponzi scheme perpetrated by R. Allen Stanford sued various law firms, insurance, and financial service companies in four state and federal securities fraud class actions. In this consolidated appeal, the Court will consider whether the Securities Litigation Uniform Standards Act (SLUSA) precludes these state law class actions against third-party actors where the complaints allege a scheme of fraudulent misrepresentation about transactions in connection with SLUSA covered securities.

*Chadbourne & Parke LLP, Willis of Colorado, Inc., Proskauer Rose LLP v. Troice*  
Docket Nos. 12-79, 12-86, 12-88

Argument Date: October 7, 2013  
From: The Fifth Circuit

by Linda S. Mullenix  
University of Texas School of Law, Austin, TX

### ISSUE

Does the preclusion provision of the Securities Litigation Uniform Standards Act of 1998 (SLUSA) prevent state and federal courts from adjudicating state law class action claims against third-party actors where the complaints allege that the defendants made misrepresentations in connection with the purchase or sale of a covered security under the act?

### FACTS

One of the most highly publicized and colorful financial fraud schemes during the past decade—paralleling the Bernie Madoff scandal—involved the financial manipulations of R. Allen Stanford and the entities he created and controlled to carry out a massive Ponzi scheme that defrauded thousands of investors in the United States and abroad. The Stanford entities included the Stanford Group Company and an affiliate, the Stanford International Bank (SIB), based in Antigua.

The Stanford Ponzi scheme involved approximately 25,000 investors who, over 15 years, purchased Stanford bank certificates of deposit (CDs). The investors were promised that the CDs would yield fixed, above-market rates of return and were assured that there was virtually no risk. The investors were promised that the CDs were backed by portfolios of liquid securities that were sold and traded on national market exchanges.

In reality, this was not true. Instead, the fresh capital of new investors in the Stanford CDs was used to make interest payments and redemptions to preexisting CD holders. Similar to the Bernie Madoff scheme, the bulk of the Stanford assets instead were diverted to

underwrite Stanford's own personal lavish lifestyle, real estate and equity acquisitions, and luxurious spending sprees. Investors included many small business owners and retirees who lost their life savings as a consequence of Stanford's fraud.

As in all such Ponzi schemes, there came a time when new investors' fresh capital into the SIB was insufficient to cover its liabilities and the Ponzi scheme collapsed, leaving thousands of investors holding the bag. The federal government criminally prosecuted R. Allen Stanford for securities fraud, and he was sentenced to jail. The Stanford entities, including the SIB, became insolvent and went into receivership.

The creation of the SIB receivership diminished the likelihood that investors would recover substantial damages for their losses. Consequently, groups of disgruntled investors looked for other potentially responsible actors involved in the fraud scheme to sue for damages. Different groups of investors instituted four separate lawsuits in federal and state court against "third-party" actors in the alleged scheme to defraud the investors.

The facts underlying the litigation that has now been consolidated on appeal involve a complicated array of these four separate civil lawsuits brought under state law in Louisiana state court and Texas federal court. In Louisiana, two different groups of plaintiffs brought two separate suits against entities and individuals who had been involved with selling the CDs, including an SEI Investments Company. Other CD purchasers brought two lawsuits under Texas law in the U.S. District Court for the Northern District of Texas. The Texas federal court was the designated multidistrict litigation (MDL) forum for all Stanford-related litigation.

The defendants in the Louisiana litigation removed those cases from state court to federal court under SLUSA's removal provisions. The Judicial Panel on Multidistrict Litigation then transferred the Louisiana cases to the Stanford MDL federal court in Texas. In this fashion, all four of the Stanford cases were before the Texas federal court. The defendants filed motions to dismiss all four complaints under SLUSA.

The defendants in these cases included two law firms, insurance companies, and financial services firms that provided the data processing systems for conducting the transactions relating to the sale of the CDs. The plaintiffs accused the law firms of aiding and abetting Stanford's Ponzi scheme, alleging in particular that Proskauer Rose LLP aided and abetted Stanford's violation of Texas security common law fraud laws by stalling an SEC investigation into Stanford's fraud.

Generally, the complaints against these third-party defendants alleged that the investors were repeatedly and uniformly told that investing in the SIB was safer than investing in U.S. banks because the SIB did not make loans but invested in safe and highly liquid instruments; that the Stanford entities were U.S. businesses regulated by the federal government; and that investment in SIB was completely safe and secure because it was guaranteed and insured by Lloyd's of London and regulated by the Antiguan banking regulatory commission and an outside audit firm. The plaintiffs alleged that the Stanford entities highlighted the high quality of SIB's investment portfolio and the importance of the liquidity of the SIB CDs.

The plaintiffs complained that contrary to these representations, the SIB did not invest in a well-diversified portfolio of marketable securities, but instead misappropriated significant portions of the bank's portfolio to SIB's sole shareholder, Allen Stanford. The Stanford entities' representations that the investors' money was being invested in safe, liquid, and completely insured investments were material misstatements because they were not true.

In addition to the SLUSA litigation against the law firm defendants, the plaintiffs in two separate actions also sued insurance brokers (collectively known as the "Willis" defendants) that assisted Stanford's bank in purchasing commercial insurance policies for the bank's operations. The plaintiffs also sued a financial service company that provided computer data processing and automated investment services to the Stanford entities. The plaintiffs pleaded claims only under state law to hold these defendants liable for billions of dollars of losses caused by the Stanford fraud. They alleged that these defendants were liable because they failed to detect Stanford's fraud. Plaintiffs' counsel specifically stated that he had pleaded only state law claims to circumvent federal law limitations on suing defendants who are only remotely connected to a primary offender in fraud cases.

The Texas federal district court held that these actions against the law firms, insurance companies, and financial services defendants were precluded by SLUSA. The SLUSA preclusion provision states: "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 ... a misrepresentation or omission of a material fact in connection with the purchase or sale

of a covered security." 15 U.S.C. § 78bb(f)(1)(A). Consequently, the court dismissed the actions.

In absence of Fifth Circuit precedent, the district court applied the Eleventh Circuit standard for determining when a misrepresentation is "in connection with" a transaction for the sale of covered securities. The Eleventh Circuit test asks whether the plaintiffs' claims "are premised on either fraud that induced the plaintiffs to invest with the defendants, or a fraudulent scheme that coincided and depended upon the purchase or sale of securities." *Instituto de Prevision Militar v. Merrill Lynch*, 546 F.3d 1340 (11th Cir. 2008).

The district court held that even though the SIB CDs were not themselves "covered securities" under the act, the marketable securities that purportedly backed the CDs were covered securities. Therefore, because SIB had led the plaintiffs to believe that the CDs were backed by SLUSA covered securities, this sufficed to bring the complaints within SLUSA's preclusion provision. In addition, the court held that at least one of the plaintiffs had exchanged a SLUSA-covered IRA investment in order to purchase an SIB CD. Thus, the SIB fraudulent scheme "coincided and depended upon the purchase or sale of securities."

The Fifth Circuit consolidated the actions and unanimously reversed the dismissals. In reaching this conclusion, the court focused on the statutory language of SLUSA requiring that a misrepresentation must be "in connection with" the purchase or sale of securities. Reviewing precedents from other circuits, the Fifth Circuit adopted the Ninth Circuit's standard, which posits that "a misrepresentation 'is in connection with' the purchase or sale of securities if there is a relationship in which the fraud and the stock sale coincide or are more than tangentially related." *Madden v. Cowen & Co.*, 576 F.3d 957 (9th Cir. 2009).

Applying this standard, the court held that none of the alleged misrepresentations in the plaintiffs' complaints satisfied SLUSA's "in connection with" requirement because the alleged misrepresentations about covered securities were only *tangentially* related to the fraud and did not go to the "heart, crux, or gravamen" of the fraud. Instead, the court held that the defendants' representations that the CDs were backed by marketable securities were one of a host of misrepresentations that induced the plaintiffs into buying the CDs.

The Fifth Circuit also rejected the plaintiffs' alternative theory for SLUSA preclusion: namely, that at least one class member had sold securities to buy the CDs. The court held that this one sale was not sufficient to satisfy SLUSA's "in connection with" requirement, because the success of the fraudulent scheme did not depend upon convincing investors to sell their securities.

## CASE ANALYSIS

The consolidated *Trice* appeals arise in the context of a complex statutory scheme regulating the securities industry, intended to protect investors from marketplace fraud. The historical centerpiece of this statutory scheme, arising out of the stock market crash of 1929, is the Securities and Exchange Act of 1934 with its core provisions against fraud in § 10(b) and Rule 10b-5.

In response to over five decades of abuses engendered by securities class action litigation—including so-called “strike suits” tailored to force quick blackmail settlements—Congress in 1995 enacted the Private Securities Litigation Reform Act (PSLRA). See P.L. No. 104-67, 109 Stat. 737. PSLRA embodied a wholesale reform of securities litigation, including heightened pleading requirements, a stay of discovery pending motions to dismiss, changes in requirements for the selection and compensation of the representational plaintiffs, and limiting damages and attorney fees.

In a series of Supreme Court decisions construing § 10(b), Rule 10(b)(5), and PSLRA, the Court consistently has held that only plaintiffs who buy and sell securities (and not mere holders of securities) can bring private actions for securities fraud. In addition, the Court consistently has held that plaintiffs can only sue primary wrongdoers but not aiders and abettors (or other third parties). See *Stoneridge Inv. Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008); *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

Prior to enactment of PSLRA, plaintiffs rarely pursued securities litigation in state court. Because of these federal law constraints, and in response to PSLRA’s restrictive provisions, class counsel turned to state court venues to pursue relief. Plaintiffs’ counsel began to divert securities litigation into state courts where plaintiffs could pursue fraud claims under state statutory and common law fraud theories and to avoid the more stringent standards of PSLRA.

In response to this stratagem, Congress answered in 1998 by enacting the Securities Litigation Uniform Standards Act. See P.L. No. 105-353, 112 Stat. 3227. The act defined a “covered security” as a publically traded security listed on a regulated national exchange. § 78bb(f)(5)(E). The act defined a “covered class action” as a lawsuit involving common questions of law or fact in which damages are sought on behalf of 50 or more people. § 78bb(f)(5)(B).

SLUSA incorporated two provisions relevant to this litigation: (1) it included a “preclusion” provision that disallowed security class actions based on state law claims, and (2) it included a removal provision that permitted defendants sued in state security class actions to remove their cases to federal court. Covered class actions brought directly in federal court under state law may be dismissed outright under the preclusion provision. SLUSA does not, however, deny any individual plaintiff or group of fewer than 50 plaintiffs the right to enforce any state law cause of action. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006).

The SLUSA preclusion provision, central to this litigation, disallows any state class or mass action that alleges “a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security.” 15 U.S.C. § 78bb(f)(1)(A). To determine whether the preclusion provision applies, a court must first determine if the facts entail a “covered security” under federal law and whether there is an alleged misrepresentation of a material fact. If so, the court must determine whether the alleged misrepresentation “is in connection with” the purchase or sale of a covered security. In this litigation, plaintiffs and defendants have argued over whether the Stanford CDs are “covered securities” and whether the alleged misrepresentations were made “in connection with” the purchase or sale of a covered security.

Both sides dispute whether SLUSA applies based on the fact that the claimants invested in SIB CDs. The plaintiffs contend that SLUSA is not even implicated because, at the threshold, bank certificates of deposit are not “covered securities” and therefore not within the ambit of the securities laws or SLUSA. The defendants, on the other hand, contend that the CDs qualify because the Stanford entities and the third-party defendants (in aiding and abetting the scheme) consistently misrepresented that the CDs were backed by liquid, market-traded securities. Also, defendants contend that at least some class members sold their securities in order to buy Stanford’s CDs. The district court endorsed the defendants’ theory; the Fifth Circuit did not.

The nub of the litigation, however, centers on the statutory construction of SLUSA’s preclusion provision, especially the “in connection with” language. The leading Supreme Court decision construing SLUSA’s “in connection with” requirement, *Dabit*, held that “it is enough that the fraud alleged ‘coincide’ with a securities transaction—whether by the plaintiff or someone else.” In addition, the Court in *Dabit* endorsed a broad reading of SLUSA, in light of the reasons for its enactment.

As indicated above, the federal circuits are split concerning construction and application of SLUSA’s “in connection with” language and the Court’s interpretation in *Dabit*. The Second and Eleventh Circuits adopted the *Dabit* test asking whether the fraud and stock sale “coincide.” The Ninth Circuit rejected this formulation and added the requirement that the fraud and stock sale must be “more than tangentially related” and go to the heart or crux of the fraud. In absence of its own precedent, the Fifth Circuit followed the Ninth Circuit’s test.

The various defendants (petitioners before the Supreme Court) have filed three separate briefs in three docketed appeals (Nos. 12-79, 12-86, and 12-88). Generally, they urge the Supreme Court to reverse the Fifth Circuit’s decision based on two broad arguments. First, they argue that the Fifth Circuit’s decision does not comport with the plain language of SLUSA or the Court’s consistently broad interpretation of the “in connection with” language. Second, they argue that allowing the plaintiffs’ state law claims to proceed as class actions in state or federal court would be contrary to and undermine the policy goals of Congress in enacting SLUSA. In addition, the Fifth Circuit’s decision improperly would undermine the Court’s carefully crafted jurisprudence regarding the liability for third-party actors, such as aiders and abettors, which the Court has prohibited.

The defendants argue that the Court in *Dabit* and other SLUSA cases repeatedly has held that the phrase “in connection with” should be broadly interpreted and applied flexibly and not technically or restrictively. The Court has held that for SLUSA purposes, the “in connection with” requirement is satisfied so long as the fraud “coincides” with the purchase or sale of a covered security. They argue that the plaintiffs’ allegations trigger SLUSA preclusion because the alleged misrepresentations are about covered securities. In addition, it does not matter that the misrepresentations were made by primary fraudsters rather than the defendants.

Moreover, the Fifth Circuit’s conclusion that the misrepresentations were too “tangential” to the “crux” of the fraudulent scheme



is wrong on the facts and the law. Defendants argue that the Fifth Circuit has rewritten the statute, and the preclusion provision is not limited to misrepresentations that are the heart, crux, or gravamen of the alleged fraud. The defendants argue that a single misrepresentation is sufficient to trigger SLUSA preclusion, and the statute does not permit plaintiffs to lard up their complaints with additional allegations to evade SLUSA preclusion (as the Fifth Circuit decision would allow plaintiffs to do). In addition, the defendants argue that the Fifth and Ninth Circuit tests are too subjective and require judicial parsing whether allegations are tangentially related or go to the heart or crux of an alleged fraudulent scheme so as to avoid SLUSA preclusion.

The defendants further argue that upholding the Fifth Circuit's decision would undermine and defeat Congress's policy judgments in enacting SLUSA and PSLRA. According to the defendants, the purpose of PSLRA was to tighten pleading and other requirements for securities class litigation in federal court. Congress enacted SLUSA to remedy circumvention of PSLRA by plaintiffs pursuing securities class actions in state court pursuant to state law theories, but the Fifth Circuit's decision would allow precisely such an end run around federal court. The defendants repeatedly point out that the Court has refused to extend liability to third-party actors far removed from the initial securities fraud violations, and SLUSA's preclusion provision reinforces this doctrine. Finally, the defendants point out that the Fifth Circuit's decision encourages artful pleading by plaintiffs, to add extraneous averments to their complaints to come within the test for "tangentially related" allegations.

In response, the plaintiffs (respondents before the Court) request that the Supreme Court uphold the Fifth Circuit's determination that SLUSA preclusion does not apply to require dismissal of these actions. The plaintiffs argue that the Fifth Circuit was correct to determine that the Stanford CDs were not covered securities, and they argue broadly that the entire statutory scheme to protect investors including the SEC Act of 1934, § 10(b), Rule 10b-5, the PSLRA, and SLUSA—was designed to deal with fraud perpetrated relating to a subset of securities traded on a U.S. national exchange.

Citing precedent, the plaintiffs argue that the Court previously has held that FDIC insured certificates of deposit issued by U.S. banks are not securities at all. *Marine Bank v. Weaver*, 455 U.S. 551 (1982). In this appeal, then, the plaintiffs contend that the defendants inappropriately are seeking to extend SLUSA to fraud involving and affecting transactions in noncovered securities.

Consequently, according to the plaintiffs, SLUSA does not preclude adjudication of the complaints forming the basis for this consolidated appeal because they do not allege a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security. In addition, as the Fifth Circuit correctly concluded, the complaints allege that the Stanford scheme included other misrepresentations that were unrelated to covered securities, such as that the CDs were insured and that SIB was closely regulated and audited.

The plaintiffs advance three further arguments. First, they argue that the securities laws do not apply when the sale of securities was an incidental consequence of a fraudulent scheme, as opposed to

the design or objective of the fraud. Second, they argue that SLUSA applies only to misrepresentations that "coincide" with securities transactions and not to misstatements about securities ownership. And third, they contend that SLUSA does not apply because SIB never made a promise to use the proceeds of the plaintiffs' CD purchases to buy additional liquid assets.

Addressing policy considerations, the plaintiffs assert that the defendants' broad reading of the "in connection with" language would expand federal jurisdiction under Rule 10b-5, permitting private purchasers and the SEC to bring lawsuits for garden-variety state fraud claims with any tangential relationship to any security. The defendants' arguments would override the allocation of federal and state regulatory authority traditionally recognized in the securities laws. Therefore, the plaintiffs conclude, the defendants' arguments raise substantial federalism concerns because Congress crafted SLUSA to respect the states' regulatory authority and police powers to preserve state common law remedies.

Finally, the plaintiffs note Congress wanted SLUSA to be easily administered at the outset of litigation, and the defendants' reading of the SLUSA preclusion provision cannot be evenly or efficiently applied in subsequent cases.

## SIGNIFICANCE

These consolidated appeals relating to the Stanford Ponzi scheme will garner extensive media attention, arising from the central colorful character of R. Allen Stanford, the extent of the fraud he perpetrated, and the ways in which Stanford personally dissipated nearly \$7 billion of his investors' assets. The cases before the Supreme Court, however, are not about Stanford or the primary defrauders, who now are in jail. In addition, the various Stanford entities are insolvent and in receivership. Instead, these appeals implicate the very important question of the ability of plaintiffs to seek recovery in class action litigation against third-parties whose actions arguably were peripheral to the original fraud.

The Court will address this question through a rather unglamorous exercise in statutory construction of SLUSA, in the context of a complicated statutory scheme of securities laws. No doubt the Court's starting point will be its *Dabit* opinion, coupled with commentary on the lower federal court's subsequent interpretation of *Dabit* and SLUSA's "in connection with" language. The Court will have to resolve the conflict on the circuits concerning whether the SLUSA language requires a broad or narrow reading to allow SLUSA preclusion to apply and require dismissal of the lawsuits.

The Court's resolution of SLUSA's reach entails a great deal at stake for potential third-party defendants such as the law firms, insurance companies, and other potential corporate defendants. These entities rely on SLUSA's preclusion provision to insulate them from vexatious securities class action litigation based on state law claims. Consequently, a number of these groups have aligned as amici in support of the defendants. In addition, potential third-party defendants fear that if the Court affirms the Fifth Circuit's decision, this will encourage future plaintiffs to engage in artful pleading to intentionally evade SLUSA's preclusion provision.

The Department of Justice and SEC have filed an amicus brief in support of the defendants, urging a broad interpretation of SLUSA and related securities laws. They argue that the securities laws, in particular the “in connection with” language, should be read to apply to any material misrepresentation “about” securities transactions. The plaintiffs respond that the Department of Justice’s amicus brief represents “an unexplained, dramatic change in the position of the agency position, which apparently had not advocated this interpretation since the adoption of the 1934 Act.” The plaintiffs argue that the DOJ is not entitled to deference and the sole purpose for the brief is to secure aggrandizement of federal agency power.

The plaintiffs contend that reversal of the Fifth Circuit’s decision will open the door to SLUSA preclusion of an array of other financial and credit transactions, “or indeed transactions of any kind.” This would accomplish a radical expansion of federal regulatory authority over security fraud claims, with a concomitant diminishment of traditional state police and regulatory authority over garden-variety fraud claims. It also would frustrate the ability of large numbers of defrauded investors to seek relief through the class action mechanism.

It remains to be seen whether the Supreme Court decides these appeals based on narrow statutory construction grounds or whether the Court decides to frame the issues in the context of broader federalism and policy concerns. If so, the Court’s conservative wing will be confronted with an interesting ideological tension between antipathy towards class litigation, pitted against a similar aversion towards expanding federal regulatory power.

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Linda S. Mullenix is the Morris & Rita Chair in Advocacy at the University of Texas School of Law. She is the author of *Leading Cases in Civil Procedure* (West 2010) and *Mass Tort Litigation* (West 2d ed. 2008). She can be reached at [lmullenix@law.utexas.edu](mailto:lmullenix@law.utexas.edu).

*PREVIEW of United States Supreme Court Cases*, pages 33–37.  
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## ATTORNEYS FOR THE PARTIES

For Petitioner Chadbourne & Parke LLP (Walter Dellinger, 202.383.5300)

For Petitioner Willis of Colorado, Inc., et al. (Paul D. Clement, 202.234.0090)

For Petitioner Proskauer Rose LLP (James P. Rouhandeh, 212.450.4000)

For Respondent Troice (Thomas C. Goldstein, 202.362.0636)

## AMICUS BRIEFS

For Petitioners Chadbourne & Parke LLP, Willis of Colorado, Inc., and Proskauer Rose LLP

Breazeale, Sachse & Wilson LLP (Lisa S. Blatt, 202.942.5000)

Causeway Capital Management LLC (Nicholas G. Terris, 202.778.9000)

DRI—The Voice of the Defense Bar (Mary Massaron Ross, 312.795.1101)

Securities Industry and Financial Markets Association (Richard D. Bernstein, 202.303.1000)

United States (Donald B. Verrilli Jr., Solicitor General, 202.514.2217)

### For Respondent Troice

Court-Appointed Receiver and the Court-Appointed Examiner (Richard B. Phillips Jr., 214.969.1700)

National Association of Bankruptcy Trustees (Paul Steven Singerman, 305.714.4343)

Occupy the SEC (Akshat Tewary, 732.287.0080)

Public Investors Arbitration Bar Association, American Association of Retired Persons, and Network for Investor Action and Protection (Royal B. Lea, 210.224.1819)

Sixteen Law Professors (Richard A. Lockridge, 612.339.6900)