McGeorge Law Review

Volume 35 | Issue 1 Article 6

1-1-2004

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Transvestite Cowboys, Thieving Brokers, and the Securities Litigation Uniform Standards Act: SLUSA's Trap for the Unwary Plaintiff

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> *"Long ago there was a strange deception: a wolf dressed in frills, a kind of transvestite."*
>
> *—Anne Sexton, "Red Riding Hood."*

I. INTRODUCTION

According to a group of dissatisfied investors, Francis H. Phillips was a wolf dressed in stockbroker's clothing.[1] Perhaps not coincidentally, he was also the owner of a transvestite cowboy nightclub into which he convinced some of his elderly clients to invest their life savings.[2] Just as the big bad wolf did not wear Grandma's nightgown for long, six months after opening, the nightclub closed and the investors lost their money.[3]

In 2002, a group of plaintiffs filed a putative class action lawsuit against First Union Securities, Inc. ("First Union") on behalf of all investors who invested through Mr. Phillips (the "*French*" litigation).[4] The plaintiffs alleged that Mr. Phillips "had an extensive history of defrauding his clients."[5] According to the plaintiffs, prior to joining First Union, Mr. Phillips used his position as a stockbroker with the investment firm Morgan Keegan to fraudulently induce a dozen of his clients to invest hundreds of thousands of dollars into his own business venture, "a cross dressing/cowboy night club named 'Cowboy[s] LaCage.'"[6] Mr. Phillips allegedly targeted elderly, unsophisticated clients to raise money for Cowboys LaCage.[7] For example, the plaintiffs alleged that Mr. Phillips persuaded a ninety-year-old man with a third-grade education to put virtually his

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1. *See* First Am. Compl. at 3-5, French v. First Union Sec., Inc., 209 F. Supp. 2d 818 (M.D. Tenn. 2002) (No. 3-02-0140) [hereinafter Amended Complaint] (copy on file with the *McGeorge Law Review*).

2. *Id.* at 3.

3. *See id.* at 3-4; Kirk Loggins, *Firm Ordered to Pay Cowboys LaCage Investors*, TENNESSEAN, Aug. 27, 1998.

4. French v. First Union Sec., Inc., 209 F. Supp. 2d 818, 823 (M.D. Tenn. 2002).

5. *Id.*

6. *See id.*; Amended Complaint, *supra* note 1, at 3.

7. Amended Complaint, *supra* note 1, at 3.

entire life savings into the "nightclub and transvestite showbar with a country western theme."[8]

Plaintiffs further alleged that First Union knew about Mr. Phillips' misconduct when it hired him, but failed to disclose it to any of his clients.[9] The plaintiffs alleged that Mr. Phillips continued to fraudulently induce unsophisticated clients to invest in Cowboys LaCage after First Union hired him despite the fact that, by this time, the venture was on the brink of bankruptcy.[10]

Cowboys LaCage opened in June 1995, featuring female impersonators performing as such celebrities as Minnie Pearl, Dolly Parton, Reba McEntire, Tina Turner, Aretha Franklin, and Barbra Streisand.[11] Six months later, the club closed when its parent company, FHP Enterprises, filed for bankruptcy.[12] Mr. Phillips blamed the closing on one of his partner's failure to secure a Corky's barbecue franchise to supply the food for the nightclub.[13]

The plaintiffs alleged that Mr. Phillips had personally guaranteed his clients' investments into Cowboys LaCage, but made no effort to repay the investors when the venture went bankrupt.[14] The plaintiffs further alleged that Mr. Phillips attempted to recover from his financial difficulties by excessively trading his clients' accounts to generate commissions for himself.[15] As a result, according to plaintiffs, by the end of 1997, more than fifteen of Phillips' customers had filed legal claims against Mr. Phillips.[16] In one case, brought against Morgan Keegan by eight former customers of Mr. Phillips who had invested in Cowboys LaCage, an arbitration panel ordered Morgan Keegan to pay over $525,000 in damages.[17]

The plaintiffs contended that First Union had a duty to disclose all of this negative information regarding Mr. Phillips, and that if the plaintiffs had known the truth about Mr. Phillips, "they never would have allowed [him] to act as their broker."[18] Accordingly, the plaintiffs sought to rescind all of their transactions with Mr. Phillips and First Union "pursuant to Tennessee Common law and the Tennessee Consumer Protection Act. . . ."[19]

By bringing their putative class action under state law rather than under the federal securities laws, the plaintiffs avoided the procedural hurdles and heightened pleading standards of the Private Securities Litigation Reform Act of 1995

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8. *Id.*

9. *Id.*; *French*, 209 F. Supp. 2d at 823.

10. Amended Complaint, *supra* note 1, at 4.

11. *See* Loggins, *supra* note 3; Paul Ladd, *Larry Edwards*, CONTEMPORA MAG., Apr. 30, 1996, at 20; Peter Applebome, *Grand Ole, Slick New Nashville*, N.Y. TIMES, Oct. 22, 1995, § 5, at 8.

12. Loggins, *supra* note 3.

13. *Id.*

14. Amended Complaint, *supra* note 1, at 4.

15. *Id.*

16. *Id.* at 5.

17. Franklin v. Morgan Keegan & Co. 1998 NASD Arb. LEXIS 1927, at *6-7 (Aug. 12, 1998).

18. French v. First Union Sec., Inc., 209 F. Supp. 2d 818, 823 (M.D. Tenn. 2002).

19. *Id.*

(PSLRA).[20] First Union, however, moved to dismiss, arguing that the Securities Litigation Uniform Standards Act of 1998 (SLUSA) preempted the plaintiffs' state law claims.[21] Had First Union prevailed with this argument, the plaintiffs' only viable class claims would have arisen under the federal securities laws and would have been subject to the PSLRA.[22]

SLUSA preempts certain class actions based upon state law if the plaintiffs allege a material misrepresentation or omission "in connection with" the purchase or sale of a security.[23] In *French*, the plaintiffs successfully convinced the court that First Union's alleged omissions were not "in connection with" the purchase or sale of a security, and that thus, SLUSA did not preempt the plaintiffs' claims based upon those alleged omissions.[24] Paradoxically, the plaintiffs' success on this argument likely contributed to the complete dismissal of their case.[25]

To the extent that the plaintiffs in *French* suffered any loss, that loss resulted from a decline in the value of the securities they purchased and sold in their accounts at First Union.[26] By convincing the court that there was no connection between First Union's alleged omissions and the purchase or sale of any securities, the plaintiffs assisted First Union in convincing the court that there was also no causal connection between those alleged omissions and any damages the plaintiffs may have suffered.[27] Accordingly, the court dismissed the plaintiffs' claims for failure to plead causation and damages.[28]

This article will examine two important issues raised by the *French* case: the application of the "in connection with" requirement of SLUSA preemption to claims for fraud relating to the opening of a brokerage account, and the link between the "in connection with" requirement and the loss causation element of both common law fraud and federal securities law fraud. Part II addresses the purposes underlying Congress's passage of the PSLRA and SLUSA, as well as the specific provisions of those acts. Because most cases interpreting the "in connection with" requirement of SLUSA rely upon cases interpreting the same language under section 10(b) of the Securities Exchange Act of 1934, Part III examines cases applying section 10(b)'s "in connection with" requirement. Courts have long been divided on the proper scope of the language, and "have not pinned down with any specificity the meaning of the requirement. . . ."[29] Part IV examines

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20. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in part at 15 U.S.C.A. §§ 77z-1, 78u-4 (West 1997)).

21. *French*, 209 F. Supp. 2d at 823.

22. *See* 15 U.S.C.A. §§ 77p(b), 78bb(f)(1) (West Supp. 2003).

23. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended in part at 15 U.S.C.A. §§ 77p, 78bb(f)).

24. *French*, 209 F. Supp. 2d at 827-28.

25. *See id.* at 832.

26. *See id.* at 831-32.

27. *See id.* at 832.

28. *Id.*

29. Ambassador Hotel Co. v. Wei-Chuan Inv., 189 F.3d 1017, 1025 (9th Cir. 1999).

the Supreme Court's most recent attempt to clarify the scope of the "in connection with" requirement of section 10(b). In an attempt to better understand what happened in *French*, Part V analyzes cases applying the "in connection with" requirement of section 10(b) and SLUSA to claims of fraud relating to the opening of a brokerage account. Under these circumstances, many courts have conflated the "in connection with" test and the loss causation test using precedent for one test to determine the outcome of the other. Finally, Part VI exposes SLUSA's trap for the unwary encountered by the plaintiffs in the *French* case: plaintiffs who attempt to circumvent the PSLRA by arguing that their class action claims are not "in connection with" the purchase or sale of a security may ultimately be unable to establish causation and consequently have their case dismissed.

This article argues that conflation of the "in connection with" and loss causation tests is inconsistent with the Supreme Court's most recent interpretation of the "in connection with" test and is inconsistent with Congress's intent in passing the PSLRA. Although there is a logical link between the two tests, the "in connection with" test is far broader. Thus, even if a defendant's alleged misrepresentations or omissions did not cause a decline in the value of the plaintiffs' investments, the claims may still be "in connection with" the purchase or sale of a security.

II. CONGRESS'S ATTEMPTS TO REFORM SECURITIES CLASS ACTION LAWSUITS

In 1995, Congress overrode President Clinton's veto and passed the PSLRA "to provide uniform standards for class actions and other suits alleging fraud in the securities market."[30] Congress intended the PSLRA to prevent "strike suits"—meritless class actions that allege fraud in the purchase or sale of securities.[31] Due to the expense of defending such suits, defendants often felt compelled to settle, regardless of the merits of the action.[32]

30. Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 107 (2d Cir. 2001); *see also* Araujo v. John Hancock Life Ins. Co., 206 F. Supp. 2d 377, 380 (E.D.N.Y. 2002). For a more detailed discussion of the legislative history of the PSLRA, see, e.g., Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV. 1003 (1998); John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975 (1996); John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996). The President's veto message appears at 141 CONG. REC. H15214 (daily ed. Dec. 20, 1995).

31. *See* H.R. CONF. REP. 104-369 at 32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731; Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1340 & n.11 (11th Cir. 2002); *Lander*, 251 F.3d at 107; *Araujo*, 206 F. Supp. 2d at 380; Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 189 F. Supp. 2d 14, 16 (S.D.N.Y. 2001); Burns v. Prudential Sec., 116 F. Supp. 2d 917, 921 (N.D. Ohio 2000).

32. H.R. CONF. REP. 104-369, at 32; *Riley*, 292 F.3d at 1340 & n.11; *Lander*, 251 F.3d at 107; *Burns*, 116 F. Supp. 2d at 921.

The PSLRA addressed these concerns by instituting, among other things, heightened pleading requirements for class actions alleging fraud in the purchase or sale of securities, a mandatory stay of discovery pending motions to dismiss, a "'safe harbor' for certain forward-looking statements," and a lead plaintiff provision.[33] With respect to the heightened standard for pleading the misrepresentation or omission element of a securities fraud claim, the PSLRA states:

> Misleading statements and omissions. In any private action arising under this chapter in which the plaintiff alleges that the defendant—
>
> (A) made an untrue statement of a material fact; or
>
> (B) omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading;
>
> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.[34]

With respect to the heightened standard for pleading the scienter element of a securities fraud claim, the PSLRA states:

> Required state of mind. In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.[35]

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33. *See* 15 U.S.C.A. §§ 77z-1, 78u-4 (West 1997 & Supp. 2003); *Riley*, 292 F.3d at 1340-41; *Lander*, 251 F.3d at 107; *Araujo*, 206 F. Supp. 2d at 380; *Burns*, 116 F. Supp. 2d at 921.

34. 15 U.S.C.A. § 78u-4(b)(1) (West 1997). For a detailed discussion of the PSLRA's heightened standard for pleading misrepresentations and omissions, see, e.g., Elliott J. Weiss, *Pleading Securities Fraud*, 64 LAW & CONTEMP. PROBS. 5 (2001); Coffee, *supra* note 30; Avery, *supra* note 30.

35. 15 U.S.C.A. § 78u-4(b)(2). For a detailed discussion of the PSLRA's heightened standard for pleading scienter, see, e.g., David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1 (1998); Elliot J. Weiss & Janet E. Moser, *Enter Yossarian: How to Resolve the Procedural Catch-22 That the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q. 457 (1998); Coffee, *supra* note 30; Elliott J. Weiss, *The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675 (1996).

With respect to the element of causation, the PSLRA states:

> Loss causation. In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.[36]

In addition to the heightened pleading requirements, the PSLRA also added procedural hurdles for plaintiffs.[37] For example, Congress found that the

> cost of discovery often forces innocent parties to settle frivolous securities class actions. According to the general counsel of an investment bank, "discovery costs account for roughly 80% of total litigation costs in securities fraud cases." In addition, the threat that the time of key employees will be spent responding to discovery requests, including providing deposition testimony, often forces coercive settlements . . . .[38]

Accordingly, the PSLRA stays all discovery "during the pendency of any motion to dismiss."[39] Congress included this provision "to prevent unnecessary imposition of discovery costs on defendants."[40]

In addition, Congress found that securities class actions were subject to manipulation by "'professional plaintiffs,' whose financial holdings in the defendant issuers were insignificant."[41] These plaintiffs and their lawyers often controlled the securities class actions, "reap[ing] huge profits, to the detriment of shareholders with more significant financial holdings."[42] A fundamental goal of the PSLRA was to ensure more effective representation of investor interests in private securities class actions by transferring control of such lawsuits from the class action plaintiffs' attorneys to the investor plaintiffs themselves.[43] To achieve this goal, the PSLRA contains a procedure for selecting a "lead plaintiff"—the plaintiff or plaintiffs most strongly aligned with the class of shareholders, and most capable of controlling the selection and actions of counsel.[44] Congress intended these mechanisms—the

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36. 15 U.S.C.A. § 78u-4(b)(4).

37. *See id.* § 78u-4(a).

38. H.R. CONF. REP. No. 104-369, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 736.

39. 15 U.S.C.A. § 78u-4(b)(3)(B). For a detailed discussion of the PSLRA's discovery stay provision, see Coffee, *supra* note 30.

40. H.R. CONF. REP. No. 104-369, at 32, *reprinted in* 1995 U.S.C.C.A.N. 730, 731.

41. *See id.*; *In re* Party City Sec. Litig., 189 F.R.D. 91, 103 (D.N.J. 1999).

42. *See* H.R. CONF. REP. No. 104, 369, at 32, *reprinted in* 1995 U.S.C.C.A.N. 730, 731, 732; *In re Party City*, 189 F.R.D. at 103; D'Hondt v. Digi Int'l Inc., Civ. No. 97-5, 1997 U.S. Dist. LEXIS 17700, at *8-9 (D. Minn. Apr. 3, 1997).

43. *See* H.R. CONF. REP. No. 104-369, at 32-35; *Party City*, 189 F.R.D. at 103; *D'Hondt*, 1997 U.S. Dist. LEXIS 17700, at *8-9.

44. *See* H.R. CONF. REP. No. 104-369, at 32-35. For a detailed discussion of the PSLRA's lead plaintiff provision, see Levine & Pritchard, *supra* note 35; Note: *Investor Empowerment Strategies in the Congressional Reform of Securities Class Actions*, 109 HARV. L. REV. 2056 (1996); Avery, *supra* note 30.

heightened pleading requirements, discovery stay, and lead plaintiff provision—"to protect investors and maintain confidence in our capital markets" by "discourag[ing] frivolous litigation."[45]

By 1998, however, Congress concluded "that many of the goals of PSLRA had not been realized."[46] Congress found that a number of securities class action plaintiffs avoided the procedural hurdles and stringent pleading requirements of the PSLRA by bringing suit in state rather than federal court.[47] By asserting claims "under state statutory or common law, these [plaintiffs were] able to assert many of the same causes of action, but avoid the heightened procedural requirements instituted in federal court."[48] Indeed, Congress found that "the decline in federal securities class action suits" following passage of the PSLRA "was accompanied by a nearly identical increase in state court filings."[49]

Congress passed SLUSA "in 1998 primarily to close this loophole in the PSLRA."[50] It did so by granting federal courts exclusive jurisdiction for class actions alleging fraud in connection with the purchase or sale of certain covered

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45. H.R. CONF. REP. No. 104-369 at 31-32; *see also, e.g.*, Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 107 (2d Cir. 2001); Phillips v. LCI Int'l, Inc., 190 F.3d 609, 620 (4th Cir. 1999).

46. *Lander*, 251 F.3d at 107; Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 § 2(3) (1998); Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1341 (11th Cir. 2002).

47. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 § 2(2) (1998); *see* Falkowski v. Imation Corp., 309 F.3d 1123, 1128 (9th Cir. 2002); *Riley*, 292 F.3d at 1341; *Lander*, 251 F.3d at 107; Araujo v. John Hancock Life Ins. Co., 206 F. Supp. 2d 377, 380 (E.D.N.Y. 2002); Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 189 F. Supp. 2d 14, 16 (S.D.N.Y. 2001); Prager v. Knight/Trimark Group, Inc., 124 F. Supp. 2d 229, 232 (D.N.J. 2000); Burns v. Prudential Sec. 116 F. Supp. 2d 917, 921 (N.D. Ohio 2000). For a detailed discussion of the migration of securities class actions from federal court to state court, see Levine & Pritchard, *supra* note 35; Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273 (1998); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Causes of Action*, 84 CORNELL L. REV. 1 (1998).

48. *Lander*, 251 F.3d at 107-08; *see* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 § 2(2) (1998); *Riley*, 292 F.3d at 1341.

49. *Lander*, 251 F.3d at 108; *see* H.R. CONF. REP. No. 105-803 (1998). When enacting SLUSA, Congress made the following findings:

> (1) the Private Securities Litigation Reform Act of 1995 sought to prevent abuses in private securities fraud lawsuits; (2) since enactment of that legislation, considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts; (3) this shift has prevented that Act from fully achieving its objectives; (4) State securities regulation is of continuing importance, together with Federal regulation of securities, to protect investors and promote strong financial markets; and (5) in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995, it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.

Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 § 2(1)-(5), 112 Stat. 3227 (1998).

50. *Lander*, 251 F.3d at 108; *Riley*, 292 F.3d at 1341; *see Falkowski*, 309 F.3d at 1128; *Araujo*, 206 F. Supp. 2d at 380; *Burns*, 116 F. Supp. 2d at 921. For a detailed discussion of the legislative history of SLUSA, see Levine & Pritchard, *supra* note 35; Walker & Seymour, *supra* note 30.

securities and by mandating that federal law govern such class actions.[51] With respect to exclusive federal court jurisdiction, SLUSA provides as follows:

> Removal of Covered Class Actions. Any covered class action brought in any State Court involving a covered security, as set forth in subsection (b), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to subsection (b).[52]

With respect to preemption of class actions arising under state law, SLUSA provides as follows:

> Class Action Limitations. 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) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
>
> (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.[53]

Thus, SLUSA preempts an action that is (1) a covered class action, (2) based on a state law, and either (3) alleging a misrepresentation or omission of a material fact, or (4) "in connection with" the purchase or sale of a covered security.[54]

SLUSA defines a "covered class action" as any lawsuit involving common questions of law or fact brought on behalf of more than fifty persons or an action brought on a representative basis on behalf of unnamed parties similarly situated.[55] SLUSA defines a "covered security" as "a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 77r(b) of this title. . . ."[56] Section 77r(b) states that a covered security is one that is, among other

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51. 15 U.S.C.A. §§ 77p(b)-(c), 78bb(f)(1)-(2) (West 1978 & Supp. 2003); *see also Riley*, 292 F.3d at 1341; *Araujo*, 206 F. Supp. 2d at 380; Painter, *supra* note 47.

52. 15 U.S.C.A. § 77p(c) (West Supp. 2003); *see also id.* § 78bb(f)(2). For a detailed discussion of SLUSA's removal provision, see Levine & Pritchard, *supra* note 35.

53. 15 U.S.C.A. § 77bb(f)(1); *see also id.* § 77p(b).

54. *See Riley*, 292 F.3d at 1342; *Araujo*, 206 F. Supp. 2d at 381; McCullagh v. Merrill Lynch & Co., No. 01 Civ. 7322, 2002 U.S. Dist. LEXIS 3758, at *7 n.2 (S.D.N.Y. Mar. 6, 2002); Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 189 F. Supp. 2d 14, 17 (S.D.N.Y. 2001); Denton v. H&R Block Fin. Advisors, Inc., No. 01 C 4185, 2001 U.S. Dist. LEXIS 15831, at *7 (N.D. Ill. Oct. 4, 2001); Shaev v. Claflin, No. C 01-0009MJJ, 2001 U.S. Dist. LEXIS 6677, at *10 (N.D. Cal. May 17, 2001); Prager v. Knight/Trimark Group, Inc., 124 F. Supp. 2d 229, 231 (D.N.J. 2000); Haney v. Pac. Telesis Group, No. CV 00-758 AHM, 2000 U.S. Dist. LEXIS 16218, at *57 (C.D. Cal. Sept. 19, 2000); *Burns*, 116 F. Supp. 2d at 921; Hines v. ESC Strategic Funds, Inc., No. 3:99-0530, 1999 U.S. Dist. LEXIS 15890, at *9 (M.D. Tenn. Sept. 17, 1999).

55. 15 U.S.C.A. §§ 77p(f)(2) & 78bb(f)(5)(B).

56. *Id.* § 77p(f)(3); *see also id.* § 78bb(f)(5)(E).

things, listed or authorized for listing on the New York Stock Exchange, the American Stock Exchange, or the NASDAQ Stock Market.[57]

SLUSA does not define the phrase "in connection with the purchase or sale" of a covered security.[58] Because the language of this clause tracks the language of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder,[59] courts have relied on case law interpreting the "in connection with" language of section 10(b) and Rule 10b-5.[60] By choosing the phrase "in connection with" the purchase or sale of a covered security, "Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired settled, and widely acknowledged, meaning in the field of securities law. . . ."[61] Accordingly, courts have presumed that Congress intended the phrase "in connection with" "to have the same meaning in SLUSA that it has in" section 10(b).[62]

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57. *Id.* § 77r(b); *Prager*, 124 F. Supp. 2d at 231.

58. *Riley*, 292 F.3d at 1342; *Araujo*, 206 F. Supp. 2d at 382; *McCullagh*, 2002 U.S. Dist. LEXIS 3758, at *8; *Hardy*, 189 F. Supp. 2d at 18; Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 01 Civ. 3013, 2001 U.S. Dist. LEXIS 15943, at *7 (S.D.N.Y. Oct. 9, 2001).

59. Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C.A. § 78j(b).

Pursuant to section 10(b), the SEC promulgated Rule 10b-5, which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 CFR § 240.10b-5 (2003).

60. *See, e.g.*, Falkowski v. Imation Corp., 309 F.3d 1123, 1129 (9th Cir. 2002); *Riley*, 292 F.3d at 1342; Green v. Ameritrade, Inc., 279 F.3d 590, 597 (8th Cir. 2002); *Araujo*, 206 F. Supp. 2d at 382; *McCullagh*, 2002 U.S. Dist. LEXIS 3758, at *8; *Hardy*, 189 F. Supp. 2d at 18; *Spielman*, 2001 U.S. Dist. LEXIS 15943, at *7; Burns v. Prudential Sec. 116 F. Supp. 2d 917, 923 (N.D. Ohio 2000). *But see* Shaw v. Charles Schwab & Co., 128 F. Supp. 2d 1270, 1272-73 (C.D. Cal. 2001) (holding that the "in connection with" language in SLUSA is narrower than under section 10(b), because, unlike section 10(b), the purpose of SLUSA is not to protect investors).

61. *Riley*, 292 F.3d at 1342-43.

62. *Id.* at 1343; *Spielman*, 2001 U.S. Dist. LEXIS 15943, at *8.

III. THE MEANING OF "IN CONNECTION WITH" UNDER SECTION 10(b)

Contrary to the Eleventh Circuit's statement that the phrase "in connection with" has a "settled and widely acknowledged meaning," other courts and commentators have acknowledged that "[c]ourts have not pinned down with any specificity the meaning of the requirement that fraud occur in connection with the purchase or sale of a security."[63] Various federal courts have employed different legal standards in applying the "in connection with" language resulting in essentially two interpretations—a broad and a narrow interpretation.[64]

The United States Supreme Court addressed the meaning of "in connection with" in *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*[65] In *Bankers Life*, New York's Superintendent of Insurance, as liquidator of Manhattan Casualty Company (Manhattan), brought a claim for securities fraud under section 10(b), alleging that the defendants had defrauded Manhattan in connection with the sale of all of Manhattan's stock.[66] Bankers Life & Casualty Company (Bankers Life), Manhattan's sole stockholder, agreed to sell all of Manhattan's stock to a Mr. Begole for $5,000,000.[67] Begole conspired with the other defendants to use Manhattan's own assets, specifically U.S. Treasury Bonds, to pay for Manhattan's stock.[68] The defendants concealed the use of Manhattan's assets to finance the purchase of its stock by purporting to transfer to Manhattan, in exchange for the bonds, a $5,000,000 certificate of deposit.[69] However, the president of Manhattan, installed immediately by the purchasers of Manhattan's stock, assigned the certificate of deposit to another corporation controlled by one of the conspirators.[70] At the conclusion of the series of transactions, Manhattan had no bonds, no certificate of deposit, indeed no assets at all, due to the defendants' fraudulent scheme to use its assets to purchase all of its shares.[71]

The district court dismissed the case and the Second Circuit affirmed, holding that "no investor [was] injured. The purity of the security transaction and the purity of the trading process were unsullied."[72] The Supreme Court reversed.[73]

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63. *Compare Riley*, 292 F.3d at 1342-43 *with* Ambassador Hotel Co. v. Wei-Chuan Inv., 189 F.3d 1017, 1025 (9th Cir. 1999); Lewis D. Lowenfels & Alan R. Bromberg, *Rule 10b-5's "In Connection With": A Nexus for Securities Fraud*, 57 BUS. LAW 1 (2001).

64. Lowenfels & Bromberg, *supra* note 63.

65. 404 U.S. 6 (1971).

66. *Id.* at 7.

67. *Id.*

68. *Id.* at 7-8.

69. *Id.* at 8.

70. *Id.*

71. *Id.* at 8-9.

72. Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 430 F.2d 355, 361 (2d Cir. 1970).

73. *Bankers Life*, 404 U.S. at 14.

In addressing the scope of the "in connection with" language in section 10(b) and Rule 10b-5, the Court began by focusing on Congress's underlying purpose.[74] The Court noted that Congress found it "practically essential" for regulatory agencies to have "broad discretionary powers" to prevent fiduciaries from taking advantage of investors' ignorance and turning legitimate practices to "illegitimate and fraudulent means."[75] In light of this purpose, the Court stated that "[s]ection 10(b) must be read flexibly, not technically and restrictively."[76] The Court thus held that the defendants' fraud was "in connection with" the sale of a security: "The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor."[77]

Courts and commentators have noted that the potential scope of the "touching" test enunciated by the Supreme Court is potentially limitless.[78] Other commentators and courts have viewed the Court's language as merely a turn of phrase providing no guidance on the meaning of the "in connection with" requirement.[79] Indeed, the Fourth Circuit concluded that "the test could not have been intended to be applied in so unlimited a way."[80] Professor Louis Loss reached the same conclusion: "there is no reason to believe that the Justice's use of 'touching' was anything more than his variation of 'in connection with' as a matter of literary style."[81]

The Court's broad but unhelpful language led to a split among courts regarding the proper scope of the "in connection with" language.[82] Courts adopting the narrow meaning of the language have held that to satisfy the "in connection with" requirement under section 10(b) and Rule 10b-5, alleged misrepresentations and omissions must pertain to the securities themselves.[83] Courts adopting the broad meaning have held that the misrepresentations and omissions need not relate to the specific securities, but rather must influence an investment decision.[84]

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74. *Id.* at 12.

75. *Id.* (quoting H.R. CONF. REP. No. 73-1383, at 6-7 (1934)).

76. *Id.*

77. *Id.* at 12-13.

78. *See, e.g.*, Lowenfels & Bromberg, *supra* note 63; Note, *The Pendulum Swings Farther: The "In Connection With" Requirement and Pretrial Dismissals of Rule 10b-5 Private Claims for Damages*, 56 TEX. L. REV. 62, 66-67 (1977); Head v. Head, 759 F.2d 1172, 1175 (4th Cir. 1985).

79. C. Edward Fletcher, III, *The "In Connection With" Requirement of Rule 10b-5*, 16 PEPP. L. REV. 913, 927 (1989); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 850 (3d ed. 1995); Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930, 942 (2d Cir. 1984).

80. *Head*, 759 F.2d at 1175.

81. LOSS & SELIGMAN, *supra* note 79, at 850.

82. *Compare Head*, 759 F.2d at 1175-76, *Chem. Bank*, 726 F.2d at 943-45, *and* Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1243 (5th Cir. 1978), *with* Press v. Chem. Inv. Serv. Corp., 166 F.3d 529, 537 (2d Cir. 1999), *and* SEC v. Jakubowski, 150 F.3d 675, 679 (7th Cir. 1998).

83. *Head*, 759 F.2d at 1175; *Chem. Bank*, 726 F.2d at 943.

84. *Press*, 166 F.3d at 537; *Jakubowski*, 150 F.3d at 679-80.

In *Wilson v. First Houston Investment Corp.*, John Wilson sued his brokerage firm under Rule 10b-5, alleging that the firm fraudulently induced him to choose First Houston by misrepresenting investment management techniques.[85] For a number of years, Wilson had maintained a stock portfolio.[86] "He became dissatisfied with his investment advisors" and "became interested in First Houston Investment Corporation after reading" articles describing its investment management techniques.[87] "[T]he articles represented that First Houston utilized a system of computer analysis of the market and . . . eliminated stocks" that did not meet "certain performance standards."[88]

Based upon these representations, confirmed by a First Houston representative, Wilson gave First Houston full discretionary authority over his stock portfolio, valued at over $100,000.[89] A year and a half later, First Houston notified Wilson that it was resigning as his investment adviser "because the account had become too small"—$5,441.00.[90] First Houston did not inform Wilson that it no longer used the computer analysis system and, in fact, had never fully used it.[91] The trial court dismissed Wilson's claim under Rule 10b-5.[92]

The Fifth Circuit affirmed.[93] Wilson argued that First Houston secured the right to purchase and sell securities on behalf of Wilson as a result of its fraud.[94] The court, however, held that the alleged misrepresentations regarding First Houston's computer analysis system were not "in connection with" the purchase or sale of a security: "We believe that any purchase and sale which took place incident to this arrangement was too remote to satisfy the 'in connection with the purchase and sale requirement. . . .'"[95] Thus, the court interpreted the "in connection with" language narrowly, holding that misrepresentations designed to induce an investor to open a brokerage account are not "in connection with" the purchases and sales of securities that subsequently occur in that account, despite the fact that those securities transactions are the sole purpose for opening the account in the first place.[96]

In *Chemical Bank v. Arthur Andersen & Co.*, four commercial banks sued the Arthur Andersen accounting firm under Rule 10b-5, alleging that Arthur Andersen induced the banks to lend money to Frigitemp Corporation and its wholly owned

85. 566 F.2d at 1237.
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.* at 1243.
93. *Id.*
94. *Id.* at 1243 n.7.
95. *Id.* at 1243.
96. *See id.*; *see also Leading Cases: III. Federal Statutes and Regulations: I. Securities Exchange Act*, 116 HARV. L. REV. 422, 427 (2002) [hereinafter *Leading Cases: III*].

subsidiary, Elsters, Inc., by misrepresenting Frigitemp's financial health.[97] Frigitemp sold, manufactured and installed "interior furnishings in hotels, restaurants, institutions and ships."[98] Frigitemp began to expand rapidly and looked to commercial banks for financing.[99]

The banks agreed to provide an $8 million line of credit to Frigitemp.[100] The banks subsequently advanced Frigitemp $15.5 million dollars in secured and unsecured notes.[101] Despite these loans, Frigitemp needed an additional $4 million of working capital to get through a "cash crunch."[102] The banks agreed to provide that additional financing for which they received notes secured by a pledge of 100% of Elsters' common stock.[103]

Frigitemp subsequently filed for bankruptcy.[104] At that time, it owed the banks approximately $11.5 million on the original $15.5 million in loans and approximately $2 million on the final $4 million loan.[105] The banks then sued Frigitemp's auditor, Arthur Andersen, under section 10(b) and Rule 10b-5 to attempt to recoup their losses.[106] Specifically, the banks alleged that Arthur Andersen knew that Frigitemp's financial statements, upon which the banks relied in deciding to lend to Frigitemp, were false and misleading.[107]

The district court denied Arthur Andersen's motion to dismiss, holding that, under the "touching test" established in *Bankers Life*, the alleged fraud was "in connection with" the purchase or sale of a security because the pledge of Elsters' stock touched upon the alleged fraud.[108] The court, however, stayed further proceedings to permit an immediate appeal of its ruling.[109]

The Second Circuit reversed.[110] The court first held that neither the notes nor the guarantees were securities.[111] The court next addressed the question of whether the alleged fraud was "in connection with" the purchase or sale of a security merely due to the pledge of Elsters' stock, despite the fact that the banks did not allege that Arthur Andersen made any misrepresentation regarding that stock.[112]

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97. 726 F.2d 930, 933 (2d Cir. 1984).
98. *Id.* at 932.
99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.* at 932-33.
103. *Id.* at 933.
104. *Id.*
105. *Id.*
106. *Id.* at 933-34.
107. *Id.* at 933.
108. *Id.* at 935.
109. *Id.* at 935-36.
110. *Id.* at 945.
111. *Id.* at 943, 945.
112. *Id.* at 943.

The banks argued that, but for Arthur Andersen's misrepresentations of Frigitemp's financial condition, the banks would not have lent money to Frigitemp, and thus there would have been no pledge of Elsters' stock.[113] The court rejected this argument, holding that "'but-for' causation is not enough."[114] The court held that to satisfy the "in connection with" requirement, the alleged misrepresentations or omissions had to pertain to the securities themselves.[115]

In *Head v. Head*, the Fourth Circuit adopted the Second Circuit's test.[116] Joan Head sued her ex-husband Howard Head under section 10(b) and Rule 10b-5, alleging that he defrauded her with respect to the property settlement of their divorce.[117] During the divorce proceedings, the lawyers for the parties worked out a property settlement.[118] In the course of those negotiations, Howard Head, the inventor of the Prince tennis racket and owner of the company that manufactured the racket (Prince Manufacturing, Inc. (PMI)), produced financial statements listing the value of his PMI stock as approximately $2.5 million.[119]

In the property settlement, Joan Head "released any claim[s] she might have had against Howard [Head] in exchange for $1,525,000, with $1,025,000 payable immediately, and $500,000 payable" a few months later.[120] The $500,000 payment was secured by 25,000 shares of PMI stock.[121] Approximately four months after Howard Head satisfied his property settlement obligations, he sold all of his PMI stock for $45 million.[122] Joan Head then sued Howard Head "alleging that the . . . property settlement [agreement] constituted a fraudulently induced 'sale' of her alleged interest in the PMI" stock in violation of section 10(b) and Rule 10b-5.[123]

Howard Head moved for summary judgment.[124] The district court granted summary judgment, holding that Joan Head had no interest in the PMI stock itself and therefore lacked standing.[125] The court also rejected Joan Head's argument that the stock-secured "portion of the property settlement constituted a fraudulently-induced purchase of the pledged stock."[126]

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113. *Id.*
114. *Id.*
115. *Id.* at 943, 945.
116. 759 F.2d 1172, 1175 (4th Cir. 1985).
117. *Id.* at 1173.
118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.*
125. *Id.* at 1173-74.
126. *Id.* at 1174.

The Fourth Circuit affirmed.[127] The court first held that under Maryland law, Joan Head did not have a property interest in the PMI stock.[128] Next, the court considered Joan Head's argument that the pledge of PMI stock by Howard Head to secure his $500,000 debt constituted a sale as to which she was the purchaser.[129] The court held that, although the pledge transaction might be considered a sale of a security, Joan Head had failed to satisfy the "in connection with" requirement.[130]

The Fourth Circuit followed the Second Circuit's decision in *Chemical Bank*: "the Second Circuit set what we agree are proper limits on the '*de minimis* touch test.'"[131] The Fourth Circuit agreed with the Second Circuit's holding that misrepresentations not pertaining to the securities themselves cannot "give rise to an action under the anti-fraud provisions of the federal securities law[s]."[132] Because Howard Head did not misrepresent the value of the stock pledged as security for his $500,000 obligation to Joan Head, his misrepresentation was not "in connection with" the purchase or sale of a security.[133]

Other courts have rejected this narrow reading of the "in connection with" language. In *SEC v. Jakubowski*, the SEC charged a lawyer under Rule 10b-5 with engaging in a fraudulent scheme to profit from circumventing banking regulations.[134] Banking regulations limit the ability of managers of mutual savings and loans to invest when a mutual converts to stock form and gives account holders a non-transferable right to purchase some of the stock.[135] For a commission, Jakubowski found account holders and convinced them to purchase stock for the benefit of a venture capital firm that was not eligible to purchase the stock in the initial offering.[136] Jakubowski completed the stock order forms for the account holders and misrepresented the identity of the true purchaser of the stock.[137]

The district court granted summary judgment to the SEC, concluding that any reasonable jury would be compelled to find that the SEC had established all of the elements of a 10b-5 claim.[138] The Seventh Circuit affirmed.[139]

With respect to the "in connection with" element, the court held that this element was satisfied because Jakubowski made statements to the issuer of securities to induce the issuer to accept his offer to buy: "How could there be a closer

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127. *Id.* at 1176.
128. *Id.* at 1174.
129. *Id.*
130. *Id.* at 1175.
131. *Id.*
132. *Id.*
133. *Id.* at 1176.
134. 150 F.3d 675, 678-79 (7th Cir. 1998).
135. *Id.* at 677.
136. *Id.* at 677-78.
137. *Id.* at 678.
138. *Id.* at 678-79.
139. *Id.* at 682.

'connection' between statements and 'the purchase or sale of any security'?"[140] The court rejected Jakubowski's argument that his fraud was not "in connection with" the purchase or sale of a security because his misrepresentations did not concern the value of the securities.[141] Instead, the court held that a misrepresentation can be "in connection with" the purchase or sale of securities if it "influences an investment decision."[142]

Similarly, in *Press v. Chemical Investment Services Corp.*, the Second Circuit adopted a broad interpretation of the "in connection with" language.[143] Donald Press purchased a Treasury bill (T-bill) through Chemical Investment Services Corp.[144] After purchasing the T-bill, Press requested that the proceeds at maturity be express mailed to him.[145] He received a check for the proceeds four days after the maturity date.[146]

Press sued Chemical Investment Securities Corp. under section 10(b) and Rule 10b-5 alleging that the defendant failed to disclose that the proceeds would not be immediately available upon maturity.[147] The district court dismissed the case, holding, in part, that the alleged omission was not "in connection with" the purchase or sale of a security.[148]

The Second Circuit affirmed the dismissal on materiality grounds, but disagreed with the district court's holding that the "in connection with" element had not been satisfied.[149] The Second Circuit "broadly construed the phrase 'in connection with,'" and held that to satisfy the element, the fraud need only somehow induce the transaction.[150] The court rejected the district court's holding that the fraud had to relate to the security itself or its value.[151]

IV. THE SUPREME COURT'S LATEST WORD ON "IN CONNECTION WITH"

In June 2002, the United States Supreme Court, in an effort to settle the uncertainty regarding the meaning of "in connection with," issued its decision in *SEC v. Zandford*.[152] In a unanimous decision, the Supreme Court held that a broker's liquidation of securities, done with the intent to misappropriate the

140. *Id.* at 679.
141. *Id.*
142. *Id.* at 680.
143. 166 F.3d 529, 537 (2d Cir. 1999).
144. *Id.* at 532.
145. *Id.* at 533.
146. *Id.*
147. *Id.*
148. *Id.* at 533-34.
149. *Id.* at 537, 539.
150. *Id.* at 537.
151. *Id.*
152. 535 U.S. 813 (2002).

proceeds, constituted a fraudulent scheme in connection with securities sales in violation of section 10(b) and Rule 10b-5.[153]

In 1987, a stockbroker named Charles Zandford "persuaded William Wood, an elderly man in poor health, to open a joint [discretionary] investment account for himself and his mentally retarded daughter."[154] Wood's investment objectives were safety of principal of $419,255 and income.[155] Zandford promised to invest Wood's money conservatively.[156] Zandford began transferring money from the Woods' account to accounts Zandford controlled and writing checks to himself from the Woods' mutual fund account.[157] Zandford had to liquidate securities held in the mutual fund account to cover the checks he wrote.[158] Before Wood died in 1991, all of the money he had entrusted to Zandford was gone.[159]

In 1991, during a routine audit of Zandford's brokerage firm, the National Association of Securities Dealers discovered more than twenty-five occasions on which Zandford had transferred funds from the Woods' account to himself.[160] A federal grand jury indicted Zandford on thirteen counts of wire fraud in violation of 18 U.S.C.A. section 1343.[161] A federal jury subsequently convicted Zandford on all thirteen counts.[162]

Meanwhile, the SEC brought civil enforcement proceedings against Zandford alleging that he violated section 10(b) and Rule 10b-5.[163] The district court, relying on Zandford's criminal conviction to preclude him from arguing that he had not violated section 10(b), granted summary judgment for the SEC and ordered Zandford to disgorge $343,000 in unlawful proceeds.[164]

The Fourth Circuit reversed the district court's order and remanded, ordering the district court to dismiss the complaint.[165] The court first held that a criminal conviction only precludes a civil issue that is identical to one that was litigated and actually determined as a necessary part of the prior criminal proceeding.[166] Under the wire fraud statute, the government had only needed to prove that "Zandford engaged in a scheme to defraud" and that he had "used inter-state wire communications in executing his scheme."[167] Because Zandford was not charged with a criminal

153. *Id.* at 825.
154. *Id.* at 815.
155. *Id.*
156. *Id.*
157. *Id.* at 815-16.
158. *Id.* at 816.
159. *Id.* at 815.
160. *Id.*
161. *Id.*
162. *Id.* at 816.
163. *Id.*
164. *Id.*
165. *Id.*; SEC v. Zandford, 238 F.3d 559, 566 (4th Cir. 2001).
166. *Zandford*, 238 F.3d at 562.
167. *Id.*

violation of section 10(b), the issue of whether Zandford's actions satisfied the "in connection with" requirement never arose.[168]

The Fourth Circuit held that this requirement must be flexible, but "not so elastic as to cover incidents which bear no relationship to market integrity or investor understanding."[169] Indeed, the court held that Zandford's fraud bore no relationship to market integrity or investor understanding, because Zandford conducted the securities sales in a "routine and customary fashion."[170] Accordingly, Zandford's securities transactions were merely "incidental to his scheme to defraud."[171] Having determined that Zandford's fraud could not possibly satisfy the "in connection with" requirement without subsuming "significant areas of state law," the court remanded the case with directions to dismiss it entirely.[172]

A unanimous Supreme Court reversed.[173] The Court began by noting that Congress passed the Securities Exchange Act of 1934, in part to insure honest securities markets and strengthen investor confidence following the stock market crash of 1929.[174] The Court explained that these objectives necessitated a flexible interpretation of the statute to effectuate its remedial purposes.[175] Noting that the SEC had consistently maintained that a broker-dealer's misappropriation of the proceeds from trading a customer's stock violated section 10(b) and had applied that interpretation in previous SEC adjudications, the Court deferred to the SEC's application of the statutory language.[176]

The Court rejected tests adopted by certain circuit courts that had held that for a fraud to be "in connection with" the purchase or sale of a security, the fraud had to concern the value of a particular stock.[177] Instead, the Court held that a Rule 10b-5 violation occurs whenever a security transaction and a fraud "coincide."[178]

Although the *Zandford* decision broadens the scope of the activities that will satisfy the "in connection with" requirement beyond those encompassed by the narrow tests previously used by some circuit courts, the new "coincidence" test does not provide much guidance.[179] One commentator has suggested that under this test misrepresentations designed to induce an investor to select a particular stockbroker or brokerage firm would qualify as "in connection with" the purchase

168. *Id.*

169. *Id.* at 563.

170. *Id.* at 564.

171. *Id.*

172. *Id.* at 566.

173. SEC v. Zandford, 535 U.S. 813, 825 (2002).

174. *Id.* at 819.

175. *Id.*

176. *Id.* at 819-20.

177. *Id.* at 820. The *Zandford* decision thus arguably overruled the Second Circuit's holding in *Chemical Bank*, *supra* note 115 and accompanying text, and the Fourth Circuit's holding in *Head*, *supra* note 133 and accompanying text.

178. *Zandford*, 535 U.S. at 825.

179. *See Leading Cases: III.*, *supra* note 96.

or sale of a security.[180] The only case to consider this issue after *Zandford*, however, reached the opposite conclusion.[181] Accordingly, although *Zandford* has likely expanded the scope of SLUSA preemption, it has not settled the question with respect to fraud relating to the opening of a brokerage account.[182]

V. FRAUD IN CONNECTION WITH SELECTING A BROKER

The vast majority of courts to consider the issue have found that misrepresentations made to induce an investor to select a particular brokerage firm or stockbroker do not satisfy the "in connection with" requirement of either section 10(b) or SLUSA.[183] This was the situation in *Wilson v. First Houston Investment Corp.*[184] First Houston's misrepresentations did not relate to the securities purchased and sold by Wilson, but rather to the system of computer analysis that induced Wilson to choose First Houston as his broker.[185] The court held that the misrepresentations were too remote from the purchases and sales to satisfy Rule 10b-5's "in connection with" requirement.[186]

The Eighth Circuit reached the same conclusion in *Green v. Ameritrade*.[187] Ameritrade provides online stock brokerage services and securities information.[188] For a twenty dollar monthly fee, Ameritrade offers its customers a real-time stock and option price quote service.[189]

Mitchell Green subscribed to this real-time quote service.[190] Green filed a putative class action lawsuit in a Nebraska state court alleging breach of contract due to Ameritrade's alleged failure to provide real-time quotes for options.[191] Green asserted that the price quotes for options lagged by as much as several hours and that, therefore, the real-time quote service subscribers were making investment decisions regarding options based upon "stale last sale information."[192]

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180. *Id.* at 430.

181. French v. First Union Sec., Inc., 209 F. Supp. 2d 818, 827-28 (M.D. Tenn. 2002).

182. *Compare id. with Leading Cases: III.*, *supra* note 96.

183. *See Leading Cases: III.*, *supra* note 96; Green v. Ameritrade, Inc., 279 F.3d 590, 597 (8th Cir. 2002); Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1243 (5th Cir. 1978); Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 01 Civ. 3013, 2001 U.S. Dist. LEXIS 15943, at *16 (S.D.N.Y. Oct. 9, 2001); Shaw v. Charles Schwab & Co., 128 F. Supp. 2d 1270, 1274 (C.D. Cal. 2001); Abada v. Charles Schwab & Co., 127 F. Supp. 2d 1101, 1103 (S.D. Cal. 2000); Laub v. Faessel, 981 F. Supp. 870, 872 (S.D.N.Y. 1997); Capalbo v. Paine Webber, Inc., 672 F. Supp. 1048, 1051-52 (N.D. Ill. 1987); Siegel v. Tucker, Anthony & R.L. Day, Inc., 658 F. Supp. 550, 553 (S.D.N.Y. 1987).

184. *See Wilson*, 566 F.2d at 1243.

185. *See id.* at 1237.

186. *Id.* at 1243.

187. 279 F.3d at 597.

188. *Id.* at 593.

189. *Id.*

190. *Id.*

191. *Id.* at 593-94.

192. *Id.* at 594.

Ameritrade removed the case to federal court and moved to dismiss pursuant to SLUSA.[193] Based upon Green's allegation that investors made decisions based upon stale information, the district court held that the alleged fraud was in connection with the purchase or sale of securities and "preempted by SLUSA," but the court denied Ameritrade's motion to dismiss, and granted Green leave to amend.[194]

Green filed an amended complaint for common law breach of contract.[195] He removed all references to any investment decisions made in reliance upon allegedly untimely information.[196] Based upon this amended complaint, the district court remanded the case to state court, holding that SLUSA did not preempt the allegations as amended.[197]

The Eighth Circuit affirmed.[198] The court held that Ameritrade's acts were not "in connection with" the purchase or sale of a security because the amended complaint did not allege any purchases or sales of securities.[199] The court further noted that Green did not request any damages for any purchase or sale of any securities.[200] In essence, Green alleged nothing more than that Ameritrade did not provide him with the information for which he paid twenty dollars per month.[201]

In *Shaw v. Charles Schwab & Co.*, a group of investors who used Charles Schwab's web site to conduct purchases and sales of securities filed a putative class action in a California state court alleging that they were overcharged on commissions and that the web-based trading system did not execute or price trades properly.[202] Charles Schwab removed that case to federal court and moved to dismiss under SLUSA, and plaintiffs moved to remand the case to state court.[203]

The court denied the motion to dismiss and remanded the case to state court.[204] The court held that the plaintiffs' claims were not "in connection with" the purchase or sale of a security because the alleged misrepresentations did not induce the plaintiffs to purchase any securities.[205] "The claims relate to the vehicle by which Schwab delivered securities rather than the securities themselves. . . . [T]he Plaintiffs contend that Defendant's fraud induced them to select Defendant as their broker rather than some other brokerage firm."[206] The court reached this conclusion

193. *Id.*
194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.*
198. *Id.* at 599.
199. *Id.* at 598.
200. *Id.* at 599.
201. *Id.* at 598.
202. 128 F. Supp. 2d 1270, 1271 (C.D. Cal. 2001).
203. *Id.*
204. *Id.* at 1274.
205. *Id.*
206. *Id.*

despite the fact that, unlike in *Green*, the sole purpose of the relationship between the plaintiffs and Charles Schwab was for the plaintiffs to purchase and sell securities.[207]

In another case involving a dissatisfied Charles Schwab customer, the court reached the same conclusion.[208] Aaron Abada filed a lawsuit in California state court against Charles Schwab alleging that he lost money trading on an internet company because, contrary to its representations, Charles Schwab failed to provide immediate execution of the trades.[209] Charles Schwab removed the case to federal court and moved to dismiss under SLUSA and Abada moved to remand.[210]

The court remanded the case to state court, holding that SLUSA did not cover the plaintiff's allegations.[211] The court concluded that Charles Schwab's conduct "had nothing to do with the trading of any particular security and any misrepresentation made by Schwab did not affect the value of the security but merely involved the relationship between Schwab and its customers."[212]

Although the conclusion was the same, this decision runs contrary to the decision in *Green*.[213] Unlike *Green*, Abada did allege the purchase and sale of a security and did seek damages resulting from those transactions.[214] Furthermore, the *Abada* court's narrow interpretation of the "in connection with" language probably did not survive the Supreme Court's statement in *Zandford* that the alleged fraud need not concern a particular security.[215]

In *Laub v. Faessel*, the alleged fraud concerned not the brokerage firm, but the broker himself.[216] John Faessel introduced himself to Kenneth Laub as a "duly registered investment advisor, specializing in advising high net worth individuals."[217] Faessel, however, was not an investment advisor, but rather a dentist.[218] Relying on Faessel's misrepresentations, Laub retained him as an investment advisor.[219] Following Faessel's investment recommendations, Laub lost over $29 million.[220]

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207. *See id.* at 1271, 1274.
208. Abada v. Charles Schwab & Co., 127 F. Supp. 2d 1101, 1103 (S.D. Cal. 2000).
209. *Id.* at 1102-03.
210. *Id.* at 1102.
211. *Id.* at 1103.
212. *Id.*
213. *Compare id. with* Green v. Ameritrade, Inc., 279 F.3d 590, 597-98 (8th Cir. 2002).
214. *See Abada*, 127 F. Supp. 2d at 1103.
215. *See* SEC v. Zandford, 535 U.S. 813, 820 (2002).
216. 981 F. Supp. 870, 870 (S.D.N.Y. 1997).
217. *Id.*
218. *Id.*
219. *Id.*
220. *Id.* at 870-71.

Laub sued Faessel under section 10(b).[221] Faessel moved to dismiss arguing that the alleged fraud was not "in connection with" the purchase or sale of a security.[222] The court granted the motion to dismiss, holding that the alleged misrepresentations did not meet the "in connection with" requirement because they related to Faessel's background and qualifications, not the securities themselves.[223]

In *McCullagh v. Merrill Lynch & Co.*, the court concluded that misrepresentations which induced the plaintiffs to select Merrill Lynch as their broker were "in connection with" the purchase or sale of securities.[224] Brian McCullagh filed a putative class action against Merrill Lynch in New York state court alleging New York statutory and common law claims.[225] McCullagh alleged that Merrill Lynch attracted customers by touting its superior research skills and use of highly skilled analysts, when, in fact, Merrill Lynch compromised the integrity of its research to increase its investment banking business.[226] According to McCullagh, in 2000, while the equity markets plunged, Merrill Lynch issued 940 buy recommendations and only seven sell recommendations as a result of its policy prohibiting negative recommendations about public companies.[227]

Merrill Lynch removed the case to federal court and moved to dismiss under SLUSA.[228] McCullagh argued that his claims concerned his choice of Merrill Lynch as a broker, rather than the purchase or sale of any specific security.[229] Merrill Lynch "argue[d] that the alleged misrepresentations [were] 'in connection with' the purchase or sale of securities because they relate[d] to the quality of the investment."[230]

The court granted the motion to dismiss, holding that Merrill Lynch's alleged misconduct was "in connection with" the purchase or sale of a security.[231] The court reasoned that, although the plaintiffs did not allege any specific stock transactions based upon Merrill Lynch's tainted recommendations, the alleged misrepresentations involved the quality of investment advice and were "clearly about the purchase of stocks. . . ."[232]

These cases addressing whether misrepresentations meant to induce investors to select a particular brokerage firm or stock broker turn on such factors as whether the complaint alleged specific securities transactions,[233] the damages sought by the

221. *Id.* at 871.
222. *Id.*
223. *Id.* at 871-72.
224. No. 01 Civ. 7322, 2002 U.S. Dist. LEXIS 3758, at *12 (S.D.N.Y. Mar. 6, 2002).
225. *Id.* at *1.
226. *Id.* at *3.
227. *Id.* at *3-4.
228. *Id.* at *2.
229. *Id.* at *7.
230. *Id.*
231. *Id.* at *12.
232. *Id.* at *11.
233. Green v. Ameritrade, Inc., 279 F.3d 590, 598 (8th Cir. 2002).

plaintiffs,[234] and whether the alleged misrepresentations related to specific securities.[235] The common thread of all of these cases, however, is the relationship between the "in connection with" requirement and the requirement that the plaintiff establish causation.

VI. SLUSA'S TRAP FOR THE UNWARY PLAINTIFF

To prevail on a fraud claim under either common law fraud or federal securities law fraud, plaintiffs must prove both transaction causation and loss causation.[236] Transaction causation refers to the requirement that the defendant's misrepresentations or omissions induce the plaintiff to make the investment; the defendant's fraud must be a but-for cause of the plaintiff's actions.[237] Loss causation refers to the link between the defendant's misconduct and the plaintiff's economic loss, rather like proximate cause.[238] The cases discussed in Parts III and V demonstrate the way in which the question of whether the "in connection with" requirement has been satisfied turns upon whether the plaintiff has alleged both transaction causation and loss causation with respect to the securities transactions at issue.

For example, the Second Circuit, in holding that Chemical Bank had not satisfied the "in connection with" requirement of its section 10(b) claim, explicitly discussed that requirement in terms of causation.[239] The court stated that the plaintiffs' showing was "simply that but for Andersen's description of Frigitemp they would not have renewed the Frigitemp loans or made the Elsters loan which Frigitemp guaranteed, and that if they had not done this, there would have been no pledge of Elsters' stock. Such 'but-for' causation is not enough."[240] Thus, the

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234. *Id.* at 599; *McCullagh*, 2002 U.S. Dist. LEXIS 3758, at *11.

235. Shaw v. Charles Schwab & Co., 128 F. Supp. 2d 1270, 1274 (C.D. Cal. 2001); Abada v. Charles Schwab & Co., 127 F. Supp. 2d 1101, 1103 (S.D. Cal. 2000); Laub v. Faessel, 981 F. Supp. 870, 871-72 (S.D.N.Y. 1997).

236. *See* 15 U.S.C.A. § 78u-4(b)(4) (West 1997); RESTATEMENT (SECOND) OF TORTS § 548A (1977); Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 95-96 (2d Cir. 2001) (applying causation requirements under section 10(b)); Rowe v. Marietta Corp., No. 97-5 789, 1999 U.S. App. LEXIS 189, at *15 (6th Cir. Jan. 6, 1999) (analogizing the causation requirements under Rule 10b-5 to New York common law fraud); Gasner v. Bd. of Supervisors, 103 F.3d 351, 360 (4th Cir. 1996) (applying the causation requirements under section 10(b)); Rousseff v. E.F. Hutton Co., 843 F.2d 1326, 1329 & n.2 (11th Cir. 1988) (applying the causation requirements under both section 10(b) and common law fraud); Mfrs. Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13, 20-21 (2d Cir. 1986) (applying the causation requirements under section 10(b) and stating that they derive from common law tort concepts); Marbury Mgmt. Inc. v. Kohn, 629 F.2d 705, 708 (2d Cir. 1980) (same); French v. First Union Sec., Inc., 209 F. Supp. 2d 818, 831-32 (M.D. Tenn. 2002) (applying the causation requirements to common law fraud).

237. *Suez Equity Investors*, 250 F.3d at 96 (comparing transaction causation to common law but-for causation); *Rousseff*, 843 F.2d at 1329 n.2.

238. *Suez Equity Investors*, 250 F.3d at 96 (loss causation "has been likened to the tort concept of proximate cause"); *Rousseff*, 843 F.2d at 1329 n.2.

239. Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir. 1984).

240. *Id.*

Second Circuit held that Arthur Andersen's alleged misrepresentations were not "in connection with" the purchase or sale of a security because, although the plaintiffs established transaction causation, they failed to establish loss causation.[241]

In *Laub*, the court also discussed the "in connection with" requirement in terms of causation, although not as explicitly.[242] In that case, the defendant argued that the case should be dismissed both because the "in connection with" requirement of section 10(b) had not been met and because the plaintiff could not prove loss causation.[243] The court addressed both arguments together.[244] The court concluded that the plaintiff had not established either the "in connection with" requirement or the loss causation requirement: "nothing suggests that Faessel's alleged fraud led to the risks incurred or losses suffered. . . ."[245]

In *Marbury Management, Inc. v. Kohn*, investors filed a lawsuit against Alfred Kohn and Wood, Walker & Co., the brokerage firm that employed Kohn, alleging violations of section 10(b).[246] The plaintiffs alleged that Kohn induced them to use his services by misrepresenting that he was a licensed stockbroker when in truth he was only a trainee.[247] The issue on appeal was whether Kohn's misrepresentation was the legal cause of the plaintiffs' losses.[248] The Second Circuit held that it was.[249]

The court acknowledged that the plaintiffs' securities did not lose value because Kohn was not a licensed stockbroker.[250] The court held that both transaction causation and loss causation had been established, however, because the misrepresentation induced the plaintiffs both to purchase the shares and to hold the shares as their value declined.[251] In essence, the court concluded that, although the misrepresentation did not relate to the intrinsic investment characteristics of the securities, it did relate to the investment quality and thus the value of the securities because, had the plaintiffs known that Kohn was an inexperienced trainee, they asserted they would not have accepted his recommendations.[252] Based upon this same rationale, the court concluded that the misrepresentation was also "in connection with" the purchase or sale of a security for purposes of section 10(b) and Rule 10b-5.[253]

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241. *Id.* at 943 & n.23.

242. Laub v. Faessel, 981 F. Supp. 870, 871-72 (S.D.N.Y. 1997).

243. *Id.* at 871.

244. *Id.* at 871-72.

245. *Id.* at 872.

246. 629 F.2d 705, 707 (2d Cir. 1980).

247. *Id.*

248. *Id.* at 708.

249. *Id.* at 710.

250. *Id.* at 708.

251. *Id.*

252. *See id.*; *see also* Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 97 (2d Cir. 2001); Mfrs. Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13, 22 (2d Cir. 1986); Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 01 Civ. 3013, 2001 U.S. Dist. LEXIS 15943, at *13-14 (S.D.N.Y. Oct. 9, 2001).

253. *Marbury Mgmt., Inc.*, 629 F.2d at 710.

Subsequent cases have relied upon the Second Circuit's analysis in *Marbury* when applying the "in connection with" test.[254] For example, in *McCullagh*, the court did not discuss the "in connection with" language in terms of causation; however, it relied heavily upon *Marbury*, which was decided on causation grounds.[255]

The Eighth Circuit's decision in *Green* also was not couched in terms of causation; however, causation issues were outcome determinative.[256] The district court found that the misrepresentations alleged in Green's initial complaint were "in connection with" the purchase or sale of a security because Green alleged that Ameritrade subscribers made investment decisions in reliance on stale price quotes provided by Ameritrade.[257] Because the amended complaint omitted that representation, the district court held, and the Eighth Circuit affirmed, that the misrepresentation was not "in connection with" the purchase or sale of a security.[258]

In affirming the district court's decision, the Eighth Circuit relied not only on the fact that the amended complaint did not allege any purchases or sales, but also on the fact that Green did not seek any damages arising from any purchases or sales.[259] Indeed, the court noted that, during oral argument, Green's counsel specifically represented that Green did not seek damages for any purchases or sales.[260] Apparently, Green realized that in order to avoid the requirements of the PSLRA he had to disavow any causal link between Ameritrade's alleged misrepresentations and any losses resulting from securities transactions.[261]

The plaintiffs in *French* did not make this realization—possibly because unlike the plaintiffs in *Green*, they had no other damages they could allege.[262] The plaintiffs in *French* alleged that First Union committed common law fraud by failing to disclose to current and prospective clients of Francis Phillips that he had an extensive history of defrauding his clients.[263] Specifically, the plaintiffs alleged that Mr. Phillips fraudulently induced elderly, unsophisticated clients to invest hundreds of thousands of dollars into a transvestite cowboy nightclub, failed to fulfill personal guarantees on his clients' investments when the nightclub went bankrupt, and then churned his clients' accounts in an attempt to recover from his financial difficulties.[264]

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254. *See* McCullagh v. Merrill Lynch & Co., No. 01 Civ. 7322, 2002 U.S. Dist. LEXIS 3758, at *9-11 (S.D.N.Y. Mar. 6, 2002); *Spielman*, 2001 U.S. Dist. LEXIS 15943, at *13-14.

255. *McCullagh*, 2002 U.S. Dist. LEXIS 3758, at *9-11.

256. Green v. Ameritrade, 279 F.3d 590, 598-99 & n.7 (8th Cir. 2002).

257. *Id.* at 594.

258. *Id.* at 594, 599.

259. *Id.* at 599.

260. *Id.* at 598 n.7.

261. *See id.*

262. *Cf.* French v. First Union Sec., Inc., 209 F. Supp. 2d 818 (M.D. Tenn. 2002).

263. *Id.* at 823.

264. *Id.*

The plaintiffs alleged that First Union committed fraud by failing to disclose this information regarding Mr. Phillips to all of his clients.[265] They also alleged that, had they known this information, plaintiffs would not have invested with either Phillips or First Union.[266] The plaintiffs did not seek damages, but rather sought to rescind all of their transactions with First Union.[267]

First Union moved to dismiss the case arguing that SLUSA preempted the plaintiffs' state law claims and that the plaintiffs had failed to allege loss causation.[268] The court rejected First Union's argument under SLUSA.[269] Following the decisions in *Chemical Bank* and *Siegel*, the court held that misrepresentations and omissions related to the selection of a broker are not "in connection with" the purchase or sale of a security.[270] Distinguishing the Supreme Court's decision in *Zandford*, the court stated:

> Although *Zandford* espoused an expansive reading of the "in connection with" language, there still must be a connection between the action and some sort of securities transaction. Where, as here, the plaintiff's claims relate to a broker's inherent fitness to execute trades and make investment decisions on behalf of their client, a fraud action is not "in connection with" the purchase or sale of a covered security.[271]

The plaintiffs' victory on this issue, however, proved hollow. The court ultimately dismissed the plaintiffs' claims in their entirety, holding that they had failed to allege any causal connection between First Union's alleged omissions regarding the broker and any financial losses suffered by plaintiffs in their investment accounts managed by the broker.[272] Analogizing the case to medical malpractice decisions, the court concluded that, although the plaintiffs had alleged transaction (or but-for) causation, they had not alleged loss (or proximate) causation.[273] In essence, on both the "in connection with" and loss causation tests, the court reached the same conclusion—there was no connection between the alleged wrongful action and the securities transactions.[274]

As the plaintiffs in *Green* apparently understood and the plaintiffs in *French* apparently did not, attempting to avoid the procedural hurdles and heightened pleading standards of the PSLRA has potentially fatal consequences to plaintiffs'

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265. *Id.*
266. *Id.*
267. *Id.*
268. *Id.*
269. *Id.* at 827-28.
270. *Id.*
271. *Id.* at 827.
272. *Id.* at 832.
273. *See id.* at 831-32.
274. *See id.* at 827-28, 831-32.

claims.[275] To avoid the PSLRA, the plaintiffs must convince the court that their claims are not "in connection with" the purchase or sale of a security.[276] However, to avoid dismissal, the plaintiffs will also have to convince the court that there is a causal link between their claims and their alleged losses.[277]

Unfortunately for plaintiffs, many courts conflate the tests for the "in connection with" requirement and the causation requirement.[278] Thus, depending upon the nature of the plaintiffs' losses, they may be put in the position of making inconsistent arguments. The plaintiffs in *Green* avoided this trap by abandoning any claims they may have had for losses on their securities transactions.[279] The plaintiffs in *French* did not avoid this trap, and consequently, instead of merely having to comply with the PSLRA, they had their claims dismissed in their entirety.[280]

This judicially created trap results from many courts' misapplication of the "in connection with" test. Consistent with the SEC's interpretation of the language, the Supreme Court has adopted a broad reading of the phrase "in connection with."[281] This broad reading encompasses situations in which the alleged fraud has no relationship whatsoever to the value of any securities, as long as the fraud and securities transactions coincide.[282] The Court found that the "in connection with" test had been satisfied despite the fact that Zandford did not induce his customers to engage in the transactions at issue.[283] Thus, to satisfy the "in connection with" requirement, plaintiffs need not prove that the defendant's alleged fraud induced the plaintiffs to engage in securities transactions.[284] Accordingly, the "in connection with" language is necessarily broader than a causal link.[285]

The language of the PSLRA further supports the proposition that the "in connection with" and loss causation tests are not coextensive.[286] In passing the PSLRA, Congress explicitly made loss causation an element of a claim under

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275. *Compare* Green v. Ameritrade, Inc., 279 F.3d 590, 598-99 (8th Cir. 2002), *with French*, 209 F. Supp. 2d at 832.

276. *See* 15 U.S.C.A. §§ 77p(b), 78bb(f)(1) (West Supp. 2003).

277. *See* RESTATEMENT (SECOND) OF TORTS § 548A (1977); Rowe v. Marietta Corp., No. 97-5789, 1999 U.S. App. LEXIS 189, at *15 (6th Cir. Jan. 6, 1999); Rousseff v. E.F. Hutton Co., 843 F.2d 1326, 1329 (11th Cir. 1988); Mfrs. Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13, 20-21 (2d Cir. 1986); Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 708 (2d Cir. 1980); *French*, 209 F. Supp. 2d at 831-32.

278. *See, e.g.*, *Green*, 297 F.3d at 598-99; Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir. 1984); *Marbury Mgmt.*, 629 F.2d at 708, 710; Laub v. Faessel, 981 F. Supp. 870, 871-72 (S.D.N.Y. 1997).

279. *See Green*, 297 F.3d at 598-99 & n.7.

280. *See French*, 209 F. Supp. 2d at 832.

281. SEC v. Zandford, 535 U.S. 813, 819-20 (2002).

282. *Id.* at 820.

283. *Id.*

284. *See id.* at 820, 825.

285. *Cf. id.*

286. *See* 15 U.S.C.A. § 78u-4(b)(4) (West 1997).

section 10(b).[287] The "in connection with" requirement, however, was already an element of such a claim.[288] Accordingly, if plaintiffs had to prove loss causation in order to satisfy the "in connection with" requirement, then it would have been superfluous for Congress to insert a loss causation requirement into claims under section 10(b).[289] Thus, Congress presumably does not believe that the two tests are coextensive.

The statutory scheme Congress created also reinforces the proposition that the "in connection with" language is broader than a causal link. Under SLUSA, a state law claim alleging fraud is only preempted if it is "in connection with" the purchase or sale of a security.[290] If SLUSA preempts a claim, the plaintiffs may then file a claim under the federal securities laws, which the PSLRA will then govern.[291] Thus, the plaintiffs will have to prove loss causation.[292]

If causation were required to satisfy the "in connection with" standard, this statutory scheme would be turned on its head. If a plaintiff class were unable to prove loss causation, rather than having their claims defeated, as Congress intended, the Court would instead conclude that the claims were not "in connection with" the purchase or sale of a security, thus governed by state rather than federal law, and thus not governed by the federal requirement of proving loss causation.[293]

The Supreme Court's broad interpretation of the "in connection with" language, coupled with the statutory scheme enacted by Congress, thus indicates that although a causal connection between the defendant's alleged fraud and a securities transaction is a sufficient condition for satisfying the "in connection with" requirement, it is not a necessary condition.[294] This leaves open the question: what is a necessary condition for satisfying the "in connection with" test?

Although the coincidence test created in *Zandford* does not provide useful guidance on its own in setting parameters for the "in connection with" test, the Court's reasoning lends itself to a useful principle.[295] In describing the required connection, the Supreme Court noted that Zandford deprived his customers of any compensation for the sale of their securities.[296] The Court analogized the case to *Bankers Life*, in which the defendants similarly deprived Manhattan Casualty Company of compensation for the sale of its securities.[297] Accordingly, the principle derived from *Zandford* is that a connection exists between the defendant's

287. *Id.*

288. *See id.* § 78j(b).

289. United States v. Nordic Vill., Inc., 503 U.S. 30, 36 (1992) ("a statute must, if possible, be construed in such fashion that every word has some operative effect").

290. 15 U.S.C.A. §§ 77p(b), 78bb(f)(1) (West Supp. 2003).

291. *See id.* § 78u-4(a) (West 1997).

292. *Id.* § 78u-4(b)(4).

293. *Cf. id.*; French v. First Union Sec., Inc., 209 F. Supp. 2d 818, 827-28, 832 (M.D. Tenn. 2002).

294. *See supra* notes 281-91 and accompanying text.

295. *Cf.* SEC v. Zandford, 535 U.S. 813, 825 (2002).

296. *Id.* at 822.

297. *Id.* at 821-22.

alleged fraud and the purchase or sale of a security when the damages the plaintiffs seek may be calculated based upon the value of the securities they purchased or sold.[298] Whether the plaintiffs can then prove a causal connection is a distinct issue.

Applying this principle would alter the holdings of many of the cases addressed in Section IV. In *Wilson v. First Houston Investment Corp.*, the Fifth Circuit held that the alleged misrepresentations regarding the defendant's computer stock selection system were not "in connection with" the purchase or sale of a security because those transactions were "too remote."[299] The plaintiff had given the defendant discretion over his account, relying on the defendant's representation that it used a computer system to analyze and select stocks.[300] In fact, the defendant had stopped using the system and had never fully used it.[301] Although the defendant's failure to use a computer system to analyze and select stocks may not have caused the decline in the value of the plaintiff's account, applying the principle derived from *Zandford*, the fraud was nonetheless "in connection with" the transactions in the account because the amount of damages alleged by the plaintiff coincided with that decline in value.[302]

In *Green v. Ameritrade*, the Eighth Circuit, in essence, reached its conclusion by applying the *Zandford* principle.[303] Green filed a claim for breach of contract due to Ameritrade's alleged failure to provide real-time quotes for options.[304] The court held that Ameritrade's acts were not "in connection with" the purchase or sale of a security in part because Green did not request any damages for any purchase or sale of any securities.[305] Instead, Green merely sought the return of the twenty dollars a month he paid Ameritrade to receive real-times quotes.[306] Because Green's alleged damages bore no relationship whatsoever to any securities transactions, the Eighth Circuit's holding that the "in connection with" test was not satisfied was consistent with *Zandford*.[307]

In *Shaw v. Charles Schwab & Co.*, plaintiffs who used Charles Schwab's web site to conduct securities transactions filed a lawsuit alleging, in part, that the web-based trading system did not price trades properly.[308] The court held that the defendant's alleged fraud did not induce securities transactions and thus was not "in connection with" the purchase or sale of a security.[309] To the extent, however, that the plaintiffs' damages were based upon the inaccurate pricing of securities

298. *Cf. id.*
299. *See* Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1243 (5th Cir. 1978).
300. *Id.* at 1237.
301. *Id.*
302. *Cf. id.*
303. 279 F.3d 590, 599 (8th Cir. 2002).
304. *Id.* at 593-94.
305. *Id.* at 599.
306. *Id.* at 598-99 & n.7.
307. *Cf. id.* at 599.
308. 128 F. Supp. 2d 1270, 1271 (C.D. Cal. 2001).
309. *Id.* at 1274.

that they purchased or sold, their damages would be calculated based upon the value of those securities. Thus, applying the *Zandford* principle, the court should have found that those claims were "in connection with" the purchase or sale of a security.

In *Laub v. Faessel*, the defendant misrepresented that he was a "duly registered investment advisor, specializing in advising high net worth individuals" when in fact he was a dentist.[310] Following the dentist's investment recommendations, the plaintiff lost over $29 million.[311] The court granted the defendant's motion to dismiss, holding that the alleged misrepresentations did not meet the "in connection with" requirement because they did not relate to the securities themselves.[312] The court found that "the losses appear to be due to market factors divorced from Faessel's deception."[313] Despite this lack of causation, because the plaintiff's alleged damages were the decline in the value of his securities, under the *Zandford* principle, his claims were "in connection with" the purchase or sale of a security.

In *McCullagh v. Merrill Lynch & Co.*, the plaintiff alleged that Merrill Lynch attracted customers by misrepresenting the integrity of its research.[314] The court held that Merrill Lynch's alleged misconduct was "in connection with" the purchase or sale of a security because the alleged misrepresentations involved the quality of investment advice and were "clearly about the purchase of stocks. . . ."[315] This decision is consistent with the *Zandford* principle because the plaintiffs' damages could be calculated based upon the change in value of the securities they purchased and sold.

Applying the *Zandford* principle to cases involving alleged fraud in connection with the selection of a broker, the result is that such cases are always "in connection with" the purchase or sale of a security, unless, as in *Green*, the plaintiffs' alleged damages are completely independent from any securities transactions.[316] This makes sense conceptually, given that the purpose of opening a brokerage account or selecting a broker is to effect securities transactions.[317] In *Green*, on the other hand, the plaintiffs contracted separately with Ameritrade to receive price quotes.[318]

This result would comport with Congress's goals in passing the PSLRA and SLUSA. Congress passed the PSLRA to discourage meritless lawsuits, such as those in which plaintiffs seek to recover the decline in the value of their securities

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310. 981 F. Supp. 870, 870 (S.D.N.Y. 1997).

311. *Id.* at 870-71.

312. *Id.* at 871-72.

313. *Id.* at 872.

314. No. 01 Civ. 7322, 2002 U.S. Dist. LEXIS 3758, at *3 (S.D.N.Y. Mar. 6, 2002).

315. *Id.* at *11-12.

316. *See supra* notes 299-315 and accompanying text.

317. *See* 15 U.S.C.A. § 78c(a)(4)(A) (West 1997) ("[t]he term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others").

318. Green v. Ameritrade, Inc., 279 F.3d 590, 593-94 (8th Cir. 2002).

despite the fact that it was not caused by any acts or omissions of the defendants.[319] Additionally, Congress passed SLUSA to prevent plaintiffs from circumventing the requirements of the PSLRA, such as the loss causation requirement.[320]

Courts' conflation of the "in connection with" test and the loss causation test have disregarded this congressional intent by permitting plaintiffs to avoid all of the requirements of the PSLRA because they do not satisfy the loss causation requirement. The Supreme Court's interpretation of the "in connection with" test in *Zandford* should preclude this situation. So far, however, it has not.

Despite the ruling in *Zandford*, the court in *French* held that the plaintiffs' allegations were not in connection with the purchase or sale of securities.[321] Accordingly, the court incorrectly held that SLUSA did not preempt the plaintiffs' state law claims.[322] Hopefully, future courts will not repeat this error and thus leave open a loophole in SLUSA that Congress sought to close. The *French* plaintiffs took little consolation from having made it through this loophole because ultimately they were caught in a trap created by it.[323] And a wolf's bite feels the same regardless of what the wolf is wearing.

319. *See* H.R. CONF. REP. No. 104-369, at 32 (1995).

320. *See* H.R. CONF. REP. No. 105-803, at 14-15 (1998).

321. *See* French v. First Union Sec., Inc., 209 F. Supp. 2d 818, 827-28 (M.D. Tenn. 2002).

322. *Id.*

323. *See id.* at 832.

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