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Expert Analysis

'Morrison,' SLUSA Make 'Group Action' Best Option for Offshore Fund Fraud

Litigation against investment managers and service providers involving fraud, breach of fiduciary duty, negligent misrepresentation and other malfeasance in connection with the demise of offshore investment funds is burgeoning. However, the Supreme Court's June 2010 decision in *Morrison v. Australia National Bank*, 130 S. Ct. 2869; 177 L. Ed. 2d 535 (2010), the Securities Litigation Uniform Standards Act of 1998 (SLUSA), as well as recent decisions of the federal district courts applying both, have limited the ways investors in offshore funds should bring these actions.

Under the new "transactional test" articulated by Justice Antonin Scalia in *Morrison*, there is no private right of action under the Securities and Exchange Act of 1934 (15 U.S.C. §78a) unless (1) the claim involves a purchase or sale of a security listed on a domestic exchange; or (2) the claim involves a purchase or sale of other securities in a domestic transaction. This means that investors in offshore funds can no longer assert federal securities claims (namely 10b-5 and 20A claims) unless those investors can establish that their purchases were "domestic transactions."

The *Morrison* decision has been commonly understood to reject "foreign cubed" cases (where a foreign plaintiff sues a foreign defendant in connection with a security purchased or sold offshore). However, a number of federal district courts have interpreted *Morrison*

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more broadly, to encompass the claims of all investors, foreign and domestic, in offshore securities transactions. See *Merkin v. Gabriel Capital, L.P.*, Nos. 08 Civ. 10922 (DAB), 09 civ. 6031, 6483 (DAB), 2011 U.S. Dist. LEXIS 112931 *30-31 (S.D.N.Y. Sept. 23, 2011) (the "argument that *Morrison* does not apply because certain Plaintiffs are U.S. residents is absurd on its face"); *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F.Supp.2d 512, 532 (S.D.N.Y. 2011), and *Harry Stackhouse v. Toyota Motor Co.*, No. 10 Civ. 0922 (DSF), 2010 U.S. Dist. LEXIS 79837 (C.D. Cal. July 16, 2010).

Federal district courts have struggled with how 'Morrison' affects transactions in shares of offshore funds that are managed in the United States.

In *Cornwell v. Credit Suisse Group*, Judge Victor Marrero held that "the *Morrison* opinions indicate that the [Supreme] Court considered that under its new test §10(b) would not extend to foreign securities trades executed on foreign exchanges even if purchased or sold by American investors, and even if some aspects of the transaction occurred in the United States." 729 F.Supp.2d 620, 625-626 (S.D.N.Y. 2010).

Effect of 'Morrison'

Federal district courts have struggled with how *Morrison* affects transactions in shares of offshore funds that are managed in the United States. It is usually the U.S.-based investment manager that engages in the reckless or fraudulent behavior (often aided and abetted by onshore and offshore service providers) that induces the investors to make investments. However, the location of the purchases or sales is less clear because, for example, subscriptions and redemptions may be processed by an offshore administrator, but forwarded to the U.S.-based manager for approval, or investment capital may be routed to a cash account at the fund's U.S.-based prime broker.

In two recent decisions concerning offshore Madoff feeder funds, federal district judges in New York required discovery on issues such as where decisions to accept investment capital and fund redemptions were made, and where shares were issued in order to determine whether purchases or sales occurred in the United States. See *Anwar v. Fairfield Greenwich, Ltd.*, 728 F.Supp.2d 372, 405 (S.D.N.Y. 2010) (case based in investment in offshore fund present[ed] a novel and more complex application of *Morrison's* transactional test); *In re Optimal U.S. Litig.*, No. 10 Civ. 4095 (SAS), 2011 U.S. Dist. LEXIS 46745, *51 (S.D.N.Y. May 2, 2011) (same).

No federal appellate court has either extended *Morrison* to apply to the claims of domestic investors in offshore funds, or held that *Morrison* applies to offshore hedge funds and other investment funds that have some nexus to the United States. However, such a holding is entirely possible in the future and the state of uncertainty makes clear that the safest approach for investors is to prosecute state law actions.

SLUSA

But in addition to *Morrison*, aggrieved investors in offshore funds must also contend with SLUSA. Under SLUSA, classes and groups of more than 50 plaintiffs may not pursue claims based on state law that are premised on "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" or where a "defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security."

"Covered" securities are limited to those that trade on one of a number of domestic exchanges. Even though offshore funds do not trade on domestic exchanges, state law claims of investors in multiple offshore Madoff feeder fund cases have been dismissed under SLUSA. The theory of these decisions is that because the feeder funds were vehicles to provide Madoff with capital to invest in covered securities, state law claims based on misrepresentations, omissions or fraud were "in connection with" the sale of covered securities. See, e.g., *In re J.P. Jeanneret Assocs Inc.*, No. 09 Civ. 3907(CM), 2011 U.S. Dist. LEXIS 9630 (S.D.N.Y. Jan. 31, 2011), *Wolf Living Trust v. FM Multi-Strategy Investment Fund, LP*, No. 09 Civ. 1540 (LBS), 2010 U.S. Dist. LEXIS 118169 (S.D.N.Y. Nov. 2, 2010), *In re Beacon Associates Litigation*, No. 09 Civ. 777 (LBS), 2010 U.S. Dist. LEXIS 106355 (S.D.N.Y. Oct. 5, 2010), and *Barron v. Igolnikov*, No. 09 Civ. 4471 (TPG), 2010 U.S. Dist. LEXIS 22267 (S.D.N.Y. March 10, 2010). *Barron* has been appealed, and the question is now pending before the U.S. Court of Appeals for the Second Circuit.

By contrast, in a non-Madoff case, *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of America Sec., LLC*, No. 05 Civ. 9016 (SAS), 2010 U.S. Dist. LEXIS 13766 (S.D.N.Y. Feb. 16, 2010), Judge Shira Scheindlin held that where the alleged misstatements related to the shares in the offshore fund itself, SLUSA did not apply, even though the fund held "covered securities" in its portfolio. Plaintiffs in the *Pension Committee* case (a group of approximately 90 investors) alleged that the investment manager of three offshore funds (along with others) had misrepresented the value of the offshore funds themselves. *Pension Committee* was decided before *Morrison*. (The authors were counsel for the group plaintiffs in *Pension Committee*.)

Group Actions

Morrison and SLUSA have a negative compounding effect on class actions arising out of the demise of offshore funds. In *In re Kingate Mgmt. Litig.*, No. 09 Civ. 5386 (DAB), 2011 U.S. Dist. LEXIS 41598 *30 (S.D.N.Y. March 30, 2011), the court held that where plaintiffs invested in a Madoff feeder fund, SLUSA would preempt any cause of action based on state law. This holding was in line with the other Madoff feeder fund cases mentioned above. What makes *Kingate* unique is that the putative class plaintiffs voluntarily dismissed all of their federal securities claims due to the *Morrison* decision. The *Kingate* court rejected the class's contention that the *Morrison* decision implicitly removed actions involving foreign transactions from the scope of SLUSA preemption. This decision illustrates a devastating whipsaw. Under SLUSA, the federal securities laws were the class plaintiffs' exclusive remedy, but under *Morrison*, the class' claims fell outside of the scope of the federal securities laws, leaving the class with no claims.

While claims under federal law may still be viable for some investors in offshore funds, the weight of the district court authority on the topic makes clear that initiating a case on the basis of federal claims alone is risky.

Due to the potential compounding effect of *Morrison* on federal claims, and SLUSA on state law claims, the class action model is no longer reliable for investors in offshore funds. *Morrison*, SLUSA and the costs of individual litigation leave these investors with one remaining good option: to band together in groups (of 50 or fewer) and prosecute actions focused on state law. SLUSA does not apply to groups of 50 or fewer investors; *Morrison* does not affect state law claims; and the group vehicle allows already-damaged investors to share the substantial costs of litigation (the principal benefit of a class action for investors in offshore funds). The main difference between a group and a class in offshore fund cases is that group plaintiffs often pay their counsel as a litigation progresses (sometimes at a discounted rate with a success premium), as opposed to a contingency fee.

Forming or finding a group can be tricky. Offshore funds do not make a habit of publishing investor lists. A typical way that a group forms is by a handful of large investors selecting counsel and then encouraging other investors to join. Large investors in a fund are likely to know other investors, and experienced counsel is likely to know entities with diverse holdings in offshore funds and funds of funds. Groups are formed through these networks. In addition, once an action is publicly filed, other investors may ask to join as well.

While claims under federal law may still be viable for some investors in offshore funds, the weight of the district court authority on the topic makes clear that initiating a case on the basis of federal claims alone is risky. And while the *Pension Committee* decision stands for the proposition that some offshore funds are not "covered securities" under SLUSA, given the number of adverse SLUSA decisions in Madoff feeder fund cases, relying on class representation to prosecute state law claims is also unwise. Therefore, group actions (of 50 or fewer) focused on state law claims are now the best option for investors damaged by fraud and other malfeasance in connection with offshore funds.

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