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In re Kingate

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The U.S. Court of Appeals for the Second Circuit, in *In re Kingate Management Limited Litigation*, recently made it significantly easier for plaintiffs in the Second Circuit and New York, Connecticut and Vermont state courts to bring class actions alleging violations of state law in litigation involving certain types of securities. By allowing these claims to proceed under state law, the Second Circuit has signaled that plaintiffs may now be able to avoid the rigorous pleading standards of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which requires that pleadings contain robust fraud allegations pleaded with particularity. The PSLRA also requires that plaintiffs allege the defendant acted with scienter—in other words, that the defendant knew the alleged statement was false at the time it was made, or was reckless in not recognizing that the alleged statement was false.

Prior to *Kingate*, most state law claims in class actions in the Second Circuit and New York state courts dealing with securities traded on U.S. exchanges were preempted by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which precludes certain class action claims under state laws if those claims are in connection with the purchase or sale of securities covered by the Securities Act of 1933 or the Securities Exchange Act of 1934 ("covered securities"). SLUSA was enacted by Congress to close a loophole that plaintiffs' attorneys were attempting to exploit in their efforts to evade the heightened pleading restrictions embodied in the PSLRA by bringing claims related to covered securities under state laws. The Second Circuit in *Kingate* may have widened that loophole once again.

The Case Against Kingate

Kingate was a class action brought in the United States District Court for the Southern District of New York on behalf of all shareholders against individuals and entities affiliated with Kingate Global Fund, Ltd. and/or Kingate Euro Fund, Ltd. (collectively, "Defendants"), which were feeder funds subject to losses resulting from Bernard Madoff's Ponzi scheme. The plaintiff class alleged that Defendants were supposed to manage the investment of funds in common stock of S&P 100 companies. Instead, Defendants' delegation of custody of the investments and all investment decisions to Bernard Madoff, who purported to purchase and sell S&P 100 securities but did not do in fact do so, resulted in investments that were, in actuality, entirely fictitious.

The 28-claim complaint, alleging false conduct and breaches of other legal duties, was based entirely on state common law and was premised on Defendants' failure to satisfy their obligations to evaluate and monitor the investment of plaintiffs' assets. Defendants moved for dismissal of the complaint, arguing that the state law claims were all precluded by SLUSA. The district court granted dismissal, holding that each of the claims was barred. The Second Circuit disagreed with respect to certain of the claims, holding that an improper standard for SLUSA analysis was used, and vacated the district court's judgment.

Claims Alleging Fraud on the Part of a Third Party

The primary issue that the Second Circuit considered on appeal was whether various groupings of claims were precluded by SLUSA. Some claims involved allegations of fraudulent misrepresentations and omissions made directly by Defendants, while other claims involved allegations of fraudulent misrepresentations and omissions made by only Bernard Madoff.

While the court held that SLUSA precluded the claims in which Defendants allegedly made direct misrepresentations, more noteworthy is the Second Circuit's analysis of the group of claims which were based not on the alleged misstatements or omissions of Defendants, but instead on the Defendants' failure to protect against and monitor the alleged misstatements attributed to Madoff.

The Second Circuit ultimately held that SLUSA did not preclude that group of claims because the allegations with respect to those claims did not include a required showing of false conduct by Defendants, and instead included only allegations of false conduct by a third party (Madoff). Before *Kingate*, the Second Circuit had never explicitly held that SLUSA contemplated preemption of only claims in which a defendant itself directly engaged in allegedly fraudulent behavior. The court in *Kingate* clarified, though, that the claims against Defendants which alleged breaches of contractual, fiduciary, and/or tort-based duties to Plaintiffs to provide competent management, consulting, auditing, or administrative services were not subject to SLUSA preemption.

Kingate's holding with respect to not allowing SLUSA preclusion based on allegations of fraud on the part of third parties puts the Second Circuit at odds with some other circuits, such as the Third and the Sixth, which in some cases allow for preclusion under SLUSA even if the allegations of false conduct are alleged to have been perpetrated by third parties without the defendant's complicity. *Kingate* makes it clear, though, that to be subjected to SLUSA preclusion in the Second Circuit, a claim must not only contain allegations involving material misstatements in connection with the purchase or sale of a covered security, but also contain allegations about a defendant's own direct activity because "[o]nly conduct by the defendant is sufficient to preclude an otherwise covered class action."

Conclusion

While it is too early to assess with certainty the impact *Kingate* will have on class action litigation in the Second Circuit and in New York state courts, the decision appears to have made it somewhat easier for classes of plaintiffs to bring state law claims in cases involving covered securities. Classes of plaintiffs looking to avoid the strict pleading requirements of the PSLRA in cases alleging fraud on the part of third parties now have good reason to litigate their claims in the Second Circuit or in New York state courts.