Supreme Court Rules State-law Securities "Holder" Class Actions Are Pre-empted

On March 21, 2006, the United States Supreme Court unanimously ruled in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*[1] that the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") pre-empts certain state-law securities claims from being brought as class actions in state court, even though federal law provides no private remedy. *Dabit* closes a perceived loophole that had allowed certain securities class actions to be brought in state court, thereby avoiding certain restrictions on securities litigation that Congress had enacted during the past decade. However, even after *Dabit*, various ways remain for institutional investors and other plaintiffs to bring securities suits under state law.

Background

Section 10(b) of the Securities Exchange Act of 1934 and its companion provision, Securities and Exchange Commission Rule 10b-5, prohibit deception, misrepresentation, and fraud "in connection with the purchase or sale of any security."[2] Although Section 10(b) does not explicitly provide for a private right of action, the Supreme Court has found such a right to be implied.[3] In *Blue Chip Stamps v. Manor Drug Stores*,[4] however, the Court limited the types of plaintiffs that had standing to bring a private damages action under Rule 10b-5 to actual purchasers or sellers of securities, rejecting standing for persons who claim they were induced by misrepresentations or omissions to continue to hold securities ("holder claims"), or to defer buying securities in the first place.

As a result of perceived abuses of securities class actions, Congress placed further obstacles in the paths of plaintiffs by enacting the Private Securities Litigation Reform Act of 1995 ("PSLRA"). This statute heightened pleading requirements for federal actions alleging securities fraud, and provided for a mandatory stay of discovery pending the determination of a motion to dismiss.[5] In response to the PSLRA, litigants shifted certain securities class actions from federal to state court, where the PSLRA's pleading requirements and discovery stay did not apply. Congress reacted by enacting SLUSA, which barred state-law class actions based on misrepresentations or omissions, or manipulative or deceptive devices, "in connection with the purchase or sale of a covered security."[6] However, because Congress in SLUSA had defined the pre-empted class action claims using the same "purchase or sale" language that the Court had interpreted in *Blue Chip* to be limited to purchasers and sellers, a question arose whether SLUSA pre-empted state-law class actions that did *not* involve purchasers and sellers.

Dabit

In *Dabit*, class plaintiffs alleged that misleading research reports by Merrill Lynch had caused brokers and their clients to hold, rather than sell, overvalued securities. The United States Court of Appeals for the Second Circuit held that SLUSA did not pre-empt these claims because the mere holding of securities was not "in connection with the purchase or sale" of securities.[7] The Seventh Circuit subsequently reached a contrary conclusion.[8] In *Dabit*, the Supreme Court resolved this circuit split by endorsing the Seventh Circuit's approach, articulating a broad construction of SLUSA's pre-emption provisions.

The Court first noted that its precedents that had addressed Section 10(b) and Rule 10b-5 had broadly interpreted the phrase "in connection with the purchase or sale" of securities. Based on these precedents, the Court concluded that in order to have a "connection with the purchase or sale of a covered security," "it is enough that the fraud alleged 'coincide' with a securities transaction – whether by the plaintiff or by someone else."[9]

Second, the Court emphasized that Congress's purpose in enacting SLUSA was to prevent state class-action securities lawsuits from frustrating the objectives of the PSLRA. Because Congress, via SLUSA, sought to prevent plaintiffs from avoiding the PSLRA's stricter federal requirements, "[a] narrow reading of the statute [SLUSA] would undercut the effectiveness of the 1995

Reform Act and thus run contrary to SLUSA's stated purpose."[10]

Interpreting Blue Chip

The Court interpreted *Blue Chip* to explain why language it had previously limited to purchasers and sellers now applied to a broader class of securities claimants. It did so by reasoning that *Blue Chip* was principally policy-driven, and that its standing limitations did not flow from the text of Rule 10b-5's language regarding a "connection with the purchase or sale" of securities, but rather from a need to restrict the scope of judicially implied private rights of action. In other words, the Court, in implying a cause of action not expressly created by Congress, could interpret the words "in connection with the purchase or sale" more narrowly without reducing the scope of that language in other contexts, like SLUSA.[11]

While seeking to demonstrate consistency between *Dabit* and *Blue Chip*, the Court nevertheless weakened a rationale for *Blue Chip*'s restrictive standing requirement. The Court in *Blue Chip* had recognized that its standing requirement reflected "an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5,"[12] but the Court had considered this disadvantage to be mitigated by remedies available to nonpurchasers and nonsellers under state law.[13] In fact, the Court in *Blue Chip* reassuringly noted that the respondent had also filed a state-court class action.[14]

In *Dabit*, by contrast, the Court disapproved of parallel class actions by holders and purchasers, asserted on identical facts, proceeding in state and federal court.[15] Although the *Dabit* Court took note of its holding's possible impact upon *Blue Chip*, it declined to "revisit the *Blue Chip Stamps* Court's understanding of the equities involved in limiting the availability of private remedies under federal law."[16]

Impact on State-law Claims

Although *Dabit*, in some respects, weakened *Blue Chip*'s analysis, it otherwise echoed and reinforced its rationale. Just as the *Blue Chip* Court limited Rule 10b-5 private-party standing requirements out of concern for the "danger of vexatious litigation which could result from a widely expanded class of plaintiffs,"[17] the *Dabit* Court limited certain state-law causes of action out of concern for "wasteful, duplicative litigation" and, in particular, for the "particularly troublesome subset of class actions" composed of holder claims.[18] The Court's objective in both opinions was the same: to minimize the number of private suits whose nuisance value outweighs their merit.

Yet even after *Dabit*, SLUSA does not pre-empt all state-law holder claims. For example, since SLUSA only denies plaintiffs the right to assert certain claims in class actions, plaintiffs are free to pursue state-law causes of action outside of the class action device.

* * *

For more information on *Dabit*, please contact Robert J. Lack (rlack@fklaw.com; (212) 833-1108) or Jonathan Gottfried (jgottfried@fklaw.com; (212) 833-1195) of our litigation group.

---

1 No. 04-1371, 547 U.S. ___ (Mar. 21, 2006); http://www.law.cornell.edu/supct/html/04-1371.ZS.html.

2 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

3 *Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

4 421 U.S. 723 (1975).

5 15 U.S.C. § 78u-4(b).

6 *Id.* § 78bb(f).

7 *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005).

8 *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005).

9 *Dabit*, slip op. at 12-13 (citation omitted).

10 *Id.* at 13-14.

11 *Id.* at 7-8, 11-12.

12 *Blue Chip*, 421 U.S. at 738 (citation omitted).

13 *Id.* at 738 n.9.

14 *Id.*

15 *Dabit*, slip op. at 14.

16 *Id.* at 15-16 n.13.

17 *Blue Chip*, 421 U.S. at 740.

18 *Dabit*, slip op. at 14.