

SECURITIES LITIGATION ALERT

SUPREME COURT HOLDS THAT SLUSA PREEMPTS CERTAIN STATE-LAW SECURITIES FRAUD CLASS ACTIONS



On March 21, 2006, the U.S. Supreme Court held in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit* that the Securities Litigation Uniform Standards Act of 1998 (SLUSA) preempts state-law securities fraud class actions filed by those who claim to have merely held – as opposed to purchased or sold – the defendant company’s shares. The Court’s decision resolves a recent conflict between circuit courts of appeals, and should also stem the rising tide of cases brought under state law by securities holders.

The 2nd Circuit, whose ruling was vacated and remanded, held that SLUSA only preempts state-law securities class action suits brought by plaintiffs who have a remedy under federal law. 395 F.3d 25 (2d Cir. 2005). The 2nd Circuit reasoned that because the federal securities laws provided remedies for only purchasers and sellers of securities, not for mere holders, SLUSA did not preempt state securities class actions brought by holders. After the 2nd Circuit’s decision, the 7th Circuit produced a contrary decision, ruling that SLUSA preempts state-law securities class actions brought by holders. *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005). The Supreme Court, in resolving the circuit split, rejected the 2nd Circuit’s narrow interpretation of SLUSA’s preemptive reach and adopted the 7th Circuit’s broader interpretation.

BACKGROUND

Rule 10b-5 essentially provides that it is unlawful to commit fraud “in connection with the purchase or sale of any security.” 17 CFR § 240.10b-5. In the seminal case addressing who can bring claims under Rule 10b-5, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court limited the field to purchasers and sellers of securities, rather than to anyone who was harmed by a violation of the Rule. The Court reasoned that “litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general,” and even frivolous cases could have a high settlement value due to the danger of business disruption. *Id.* at 739-40. Limiting claims to purchasers and sellers would help to ameliorate this danger.

Despite this limitation, in the years since *Blue Chip Stamps* was decided, securities fraud class actions became something of a litigation industry, with so-called strike suits brought against public companies that would settle rather than undergo costly discovery. In response, Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA), which among other

things greatly heightened pleading standards in securities fraud class actions and stayed discovery until a court determined the legal viability of the complaint.

One consequence of this was that some plaintiffs began filing securities class actions based on state law, thereby avoiding the strictures of the PSLRA. Congress again acted, passing SLUSA in 1998, which preempts most class actions “based upon the statutory or common law of any State” that allege a defendant made a material misrepresentation or omission, or used or employed a manipulative or deceptive device, “in connection with the purchase or sale of a covered security.” 15 U.S.C. § 78bb(f)(1).

BRIEF ANALYSIS

The key issue in *Dabit* was whether SLUSA’s “in connection with” language preempted only those cases brought by purchasers or sellers of securities, or whether it also preempted cases brought by holders of securities. The defendants in *Dabit* argued that because the Supreme Court’s holding in *Blue Chip Stamps* limits 10b-5 standing to purchasers and sellers, and because SLUSA contains almost identical “in connection with the purchase or sale” language as Rule 10b-5, SLUSA should preempt only suits brought by purchasers and sellers.

The Court rejected this argument, explaining that its holding in *Blue Chip Stamps* was the result of policy considerations, rather than a textual analysis of the “in connection with” language in Rule 10b-5. Thus, the Court in *Blue Chip Stamps* did not determine the meaning of “in connection with,” but instead had made a policy decision to limit standing to bring a powerful and destructive cause of action to a smaller class of litigants.

As to the meaning of “in connection with,” the *Dabit* Court explained that in the context of Rule 10b-5, this language had always been interpreted broadly, to include fraud that merely coincides with a securities transaction. When Congress enacted SLUSA, it intended for the “in connection with” language to be as broad as that in Rule 10b-5. Thus, a suit filed by any litigant – purchaser, seller or holder – “in connection with” a securities transaction would be preempted under SLUSA. The Court noted that this conclusion is supported by SLUSA’s express purpose, which is to prevent litigants from attempting to avoid the PSLRA’s strictures by bringing class actions based on state law.

Finally, responding to arguments regarding the general presumption against preemption, the Court noted that state law claims could still be brought, just not as class actions. Further, SLUSA carves out exceptions for, among others, derivative actions, certain class actions based on the law of a corporation’s state of incorporation, and state agency enforcement proceedings.

The *Dabit* case certainly further clarifies the preemptive reach of SLUSA, and confirms that federal law is and will remain the primary vehicle for redressing securities fraud claims.

CONTACT INFORMATION

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