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State Securities Class Action Suits: Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit

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Summary

The Second Circuit held that in certain instances the federal Securities Litigation Uniform Standards Act of 1998 (SLUSA) does not preempt securities state class action suits. Four months after the Second Circuit decision, the Seventh Circuit took a very different approach to the issue. On March 21, 2006, the Supreme Court unanimously (Justice Alito took no part in consideration of the case.) vacated the judgment of the Second Circuit and held that the background, text, and purpose of SLUSA's pre-emption provision indicate that SLUSA pre-empts state law holder class action claims of the type that Dabit alleges. This report will not be further updated.

Two separate appeals brought by former and current Merrill Lynch brokers (Dabit) and by a Merrill Lynch retail brokerage customer (IJG Investments), alleging that Merrill Lynch issued biased research and investment recommendations about companies in order to obtain investment banking business, were consolidated by the Second Circuit as *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*.[1] The earlier cases had been dismissed as preempted by the Securities Litigation Uniform Standards Act of 1998 (SLUSA).[2]

SLUSA was enacted in response to the perceived failure of the Private Securities Litigation Reform Act of 1995 (PSLRA)[3] to curb alleged abuses of securities fraud litigation. PSLRA set out a framework for the bringing of securities fraud cases in federal courts. In many instances, plaintiffs circumvented PSLRA by bringing cases in state courts on the basis of common law fraud or other non-federal claims. SLUSA attempted to make certain that plaintiffs could not avoid the PSLRA requirements by requiring securities fraud cases to be brought only in federal court and only under a uniform standard if five criteria are satisfied: (1) The lawsuit is a covered class action; (2) The

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[1] 393 F.3d 25 (2d Cir. 2005).

[2] P.L. 105-353, 112 Stat. 3227.

[3] P.L. 104-67, 109 Stat. 737.

claim is based on state statutory or common law; (3) The claim concerns a covered security; (4) The plaintiff alleges a misrepresentation or omission of a material fact; and (5) The misrepresentation or omission is made in connection with the purchase or sale of a covered security.

The Second Circuit court examined the language of section 10(b) of the Securities Exchange Act,[4] which is the general antifraud provision of the act, and Rule 10b-5,[5] the rule issued by the Securities and Exchange Commission (SEC) to implement the statutory provision. In its examination, the court found that the "in connection with" requirement of SLUSA should be interpreted in the same way that courts have interpreted the phrase in the antifraud provision and in the Rule. In its analysis of past cases which have interpreted this statute and Rule, the Second Circuit stated that the fraud at issue must be "integral to the purchase and sale of the securities in question."[6] Further, in Blue Chip Stamps v. Manor Drug Stores[7] the Supreme Court ratified the doctrine that a private litigant may bring an antifraud action only if an actual purchaser or seller of the securities in question.

The Second Circuit found it necessary to look at judicial interpretations of the "in connection with" requirement and the standing issue of a private litigant in order to determine whether standing under SLUSA would be comparable and whether SLUSA could be found to preempt all claims that might be brought under state law. The court found that in enacting SLUSA Congress sought only to ensure that class actions brought by plaintiffs satisfying the actual purchaser-seller requirement are subject to the federal securities laws.

> SLUSA, as we have repeatedly noted, was intended to bolster the PSLRA, which in turn was intended to toughen the requirements for maintenance of a successful action under Rule 10b-5. We need not and do not reach the question, but see no contradiction in concluding that Congress could have intended to preempt state law securities fraud actions that if brought under federal law would fail for proof of loss causation or lack of timely filing, but did not intend to preempt a category of actions that, because of the nature of the injury alleged, could never have constituted a potential federal action.[8]

The remainder of the court's opinion concerned the damages claims by the parties. Dabit asserted claims for two types of damages: 1. holding damages concerning Merrill Lynch's dissemination of fraudulent information which induced him and the class which he represented to retain certain securities and 2. commissions that Dabit would have earned from clients which he lost because of Merrill Lynch's dissemination of allegedly fraudulent information. As for the claim for holding damages, the court stated that, because this kind of claim did not satisfy the *Blue Chip* standing requirement necessary for the "in connection with" requirement of the antifraud provision and its Rule, SLUSA

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[4] 15 U.S.C. § 78j(b).

[5] 17 C.F.R. § 240.10b-5.

[6] *Dabit*, at 37.

[7] 421 U.S. 723 (1975).

[8] *Dabit*, at 43.

did not generally preempt these holding claims. However, when Dabit asserted that he and the class which he represented both purchased and retained stocks based upon Merrill Lynch's misrepresentation, he satisfied the *Blue Chip* standing requirement and ran afoul of SLUSA, which was intended to preempt claims alleging fraud in connection with the purchase or sale of securities. The court ordered that these claims be dismissed without prejudice so that the plaintiff might plead a claim sounding in state law if possible. His claim concerning lost commissions, brought on behalf of himself and other brokers, fared better than the holdings claim, with the court stating that this kind of claim by its nature did not allege fraud coinciding with the purchase or sale of a security. The court therefore allowed this claim as not preempted by SLUSA.

IJG Investments attempted to recover damages caused by paying commissions or fees to Merrill Lynch by entities having brokerage accounts with Merrill Lynch. The court held that claims for flat annual fees were not preempted by SLUSA but that claims for commissions were preempted because commissions by definition involve allegations of a purchase or sale of securities "in connection with" the alleged conduct.

In April 2005, four months after *Dabit*, the Seventh Circuit rejected the Second Circuit approach. The Seventh Circuit held in *Kircher* v. *Putnam Funds Trust*[9] that "SLUSA is as broad as § 10(b) itself and that limitations on private rights of action to enforce § 10(b) and Rule 10b-5 do not open the door to litigation about securities transactions under state law."[10] "It would be more than a little strange if the Supreme Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all."[11]

On September 25, 2005, the United States Supreme Court granted the petition for writ of certiorari to the United States Court of Appeals for the Second Circuit.[12] On March 21, 2006, the United States Supreme Court unanimously[13] vacated the judgment of the Second Circuit. The Court stated that the argument of respondent, adopted by the Second Circuit, that the operative language of "in connection with" must be read narrowly to pre-empt only those actions in which the purchaser-seller requirement of *Blue Chip Stamps* is met, is inaccurate and must be rejected.

The Court went on to discuss its belief that Congress must have been aware of the broad construction of the phrase "in connection with the purchase or sale" adopted by both the Court and the Securities and Exchange Commission when Congress used this key phrase in SLUSA.

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[9] 403 F.3d 478 (7th Cir. 2005).

[10] *Kircher*, at 484.

[11] *Id.* at 484.

[12] No. 04-1371.

[13] Justice Alito took no part in consideration of the case.

> And when "judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its...judicial interpretations as well."[14]

In buttressing its holding that Congress intended a broad interpretation of "in connection with the purchase or sale," the Court stated:

> The presumption that Congress envisioned a broad construction follows not only from ordinary principles of statutory construction but also from the particular concerns that culminated in SLUSA's enactment. A narrow reading of the statute would undercut the effectiveness of the 1995 Reform Act and thus run contrary to SLUSA's stated purpose, viz., "to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the 1995 Act.[15]

Finally, in response to the argument that the holder class action brought by respondent was distinguishable from a typical class action because it was not brought by a required purchaser or seller of the securities, the Court stated that the identity of the plaintiffs does not determine whether the complaint alleges fraud "in connection with the purchase or sale" of securities.

> The misconduct of which respondent complains here — fraudulent manipulation of stock prices — unquestionably qualifies as fraud "in connection with the purchase or sale" of securities as the phrase is defined....[16]

The Court therefore vacated the judgment of the Court of Appeals for the Second Circuit and remanded the case for further proceedings consistent with its opinion.

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[14] Slip op., at 13 [citation omitted].

[15] Slip op., at 13-14 [citation omitted].

[16] Slip op., at 16.

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