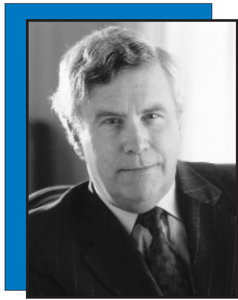

Dabit—A Death Knell for State Class Action Securities Holder Claims

By Edwin L. Noel and Laura L. McLaughlin

The magnitude of the federal interest in protecting the integrity and efficiency of the national securities market cannot be overstated.[1]

The Securities Litigation Uniform Standards Act of 1998 (SLUSA) preempts state class action claims pleading a deceit coinciding with a transaction of a covered security, regardless of who brings the claim. Federal, not state, law is the exclusive vehicle to assert any securities class action fraud claims. SLUSA squarely preempts a broad swath of state-law class action claims, regardless of whether the class plaintiff is a purchaser, seller, holder of covered securities, or someone else. SLUSA's preemption is solid and exists although a federal private remedy may not. Stated differently, SLUSA's broad preemption preempts class holder causes of action even though holders do not have a private right of action under federal securities fraud laws. This was the unanimous and clear holding of the U.S. Supreme Court's decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*.[2]

This article outlines the magnitude of federal protection of the securities market as stated by the *Dabit* Court and, thereby, SLUSA's preemptive effect on state-law claims. In light of *Dabit* and the broad congressional intent of SLUSA's preemption, this article also addresses the pleadings necessary for a defendant to prove SLUSA preemption.

Federal Regulation and Protection Is Paramount

In response to the sudden and disastrous collapse in listed stock prices in 1929, and the Great Depression that followed, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934.[3] Since their enactment, these two statutes have anchored federal regulation of vital elements of our economy.[4]

Beginning in 1946, courts, not Congress, created the private right to pursue securities fraud claims.[5] In 1952, the Second Circuit limited Rule 10b-5's private right of action to purchasers and sellers and excluded a claim brought by a corporation and its shareholders alleging fraud "in connection with" a director's sale of stock to third parties.[6] Hundreds of lower courts accepted the Second Circuit's unstated standing conclusion that Rule 10b-5 claims can only be brought by purchasers and sellers.[7] In 1975, the Supreme Court first confronted the standing limitation directly. In *Blue Chip Stamps v. Manor Drug Stores,* relying on policy considerations and judicial precedent, the Court limited the private fraud remedy to purchasers and sellers.[8] According to the *Blue Chip Stamps* Court, the principal policy consideration tipping the scales in favor of limiting causes of actions to actual purchasers or sellers was the widespread recognition that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[9] In response to this danger, *Blue Chip Stamps* adopted a purchaser-seller standing requirement for private securities fraud claims.

Twenty years after *Blue Chip Stamps,* prompted by the same policy considerations, Congress adopted legislation targeted against perceived abuses of the class action device that were used to injure "the entire U.S. economy."[10] According to Congress, nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and "manipulation of class action lawyers of the clients whom they purportedly represented" had become rampant.[11] In 1995, the Private Securities Litigation Reform Act (PSLRA or Reform Act) was codified, adopting numerous safeguards, including heightened pleading standards, sanctions for frivolous litigation, "safe harbors" for forward-looking statements, and a stay of discovery pending resolution of motions to dismiss.[12] Notably, however, the PSLRA did not eliminate or address state-law claims of nonpurchasers and nonsellers—including those who simply held their securities because of claimed fraudulent misrepresentations.

The plaintiffs' bar responded by avoiding the federal forum altogether and bringing class claims under state law in state court.[13] This "federal flight" loophole allowed litigants to circumvent the PSLRA's heightened pleading standards and stay of discovery by bringing suit in state courts under state statutory or common law rather than federal law. This strategy prevented the PSLRA from fully achieving its objectives of preventing abuses in private securities fraud lawsuits.[14]

Responding to this loophole, in 1998 Congress enacted SLUSA. In enacting SLUSA, Congress intended to close the loophole by making federal courts the exclusive venue for class actions alleging fraud in the sale of certain covered securities and by mandating that such class actions be governed exclusively by federal law. Yet, SLUSA preserved the enforcement powers of state securities regulators and the current treatment of individual law suits.[15] By SLUSA, Congress drew a line between class

actions and other types of securities litigation. The core provision of SLUSA reads as follows:

> (1) Class Action Limitations.—No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
> (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
> (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.[16]

A "covered class action" is a lawsuit in which damages are sought on behalf of more than 50 people.[17] As stated, SLUSA provides that federal securities law preempts state law. SLUSA further provides that any covered class action "shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to paragraph (1)."[18]

Therefore, if a plaintiff files a covered class action in state court, under SLUSA, the case either should be dismissed by the state court or, alternatively, removed to the federal court by the defendant.

Dabit's Fraud Claim

Shadit Dabit is a former broker of Merrill Lynch, Pierce, Fenner & Smith, Inc.[19] In the course of Dabit's employment, he purchased stocks for himself and his clients between December 1, 1999, and December 31, 2000.[20] Sparked by New York Attorney General Elliott Spitzer's investigation, Dabit and others initiated private securities fraud class actions.[21] Rather than rely on the federal securities laws, Dabit invoked the district court's diversity jurisdiction and advanced his class claims under Oklahoma state law, allegedly based on the research provided by Merrill Lynch's research department.[22] What began as a class of brokers who "purchased" securities during the class period became a class of brokers who "owned and continued to own" securities during the class period (holders).[23]

Dabit asserted that Merrill Lynch's actions damaged the class members in two ways: the misrepresentations and manipulative tactics caused them to hold onto overvalued securities, and brokers lost commissions when their clients, now aware that they had made poor investments, took their business elsewhere.[24] Meanwhile, dozens of other suits similar to Dabit's had been filed against Merrill Lynch around the country on both federal and state-law theories of liability.[25] Dabit's case was transferred to the Judicial Panel on Multidistrict Litigation for consolidation of pretrial proceedings where it was dismissed based on SLUSA's preemption.[26]

The Second Circuit vacated the dismissal, concluding that holder claims did not allege fraud "in connection with the purchase or sale" of securities under SLUSA.[27] The court agreed that the phrase used in other federal securities laws was broadly defined by the Supreme Court but held that Congress nonetheless intended a narrower meaning for SLUSA scope—one that incorporates the standing limitation announced in *Blue Chip Stamps*.[28] The Second Circuit's analysis hinged on its conclusion that SLUSA preempted only purchaser and seller claims, not claims brought by those who retained or delayed selling their securities.[29] Under the Second Circuit's analysis, a class action limited to holders could be sustained under state law.[30]

> Many courts have already applied SLUSA's broad preemption to several state-law claims.

A few months later, the Seventh Circuit ruled to the contrary, holding that SLUSA preempted holder state-law class-action claims.[31] The division among the circuits turned on the meaning of SLUSA's phrase "in connection with the purchase or sale."

The *Dabit* Decision

The *Dabit* Court rejected the Second Circuit's narrow interpretation of SLUSA's preemption to exclude holder claims and confirmed that the Court will continue to broadly interpret the phrase "in connection with the purchase or sale of a covered security."[32] The *Dabit* Court stated that allegations of fraud that "coincide" with a securities transaction—whether by the plaintiff or by someone else—are sufficient.[33] The requisite showing, in other words, is deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller.[34] Further, according to the Court, Congress must have been aware of the broad construction adopted both by the Court and SEC when it imported the key phrase used in section 10(b) and Rule 10b-5 "in connection with the purchase or sale" into SLUSA's core provision.[35] *Dabit* holds that the *Blue Chips Stamps* standing limitation does not allow a class plaintiff to avoid SLUSA's preemption of state-law claims. *Dabit* did not reject the *Blue Chip Stamps* standing limitation to federal security fraud causes of actions.[36]

The Second Circuit's narrow reading of the statute undercut the effectiveness of the PSLRA and thus ran contrary to SLUSA's stated purpose to prevent certain state private securities class action lawsuits alleging fraud from being used to frustrate SLUSA's objectives.[37]

Pleadings after *Dabit*

Litigants asserting deception in connection with the purchase or sale of a covered security have two choices—litigate individually or join a class. As an individual litigant, the person has the right to select his venue and remedies, including the right to pursue state-law claims in state court; as a member of a covered class, now he can only bring federal claims to federal court (because

state claims and jurisdiction are preempted).

Many courts have already applied SLUSA's broad preemption to several state-law claims including breach of contract,[38] breach of fiduciary duty claims,[39] violations of state deceptive trade practices acts or consumer protection acts,[40] unjust enrichment,[41] negligence, and negligent supervision[42] claims.

The key question, not directly answered by the *Dabit* Court, is what determines whether a party has alleged a SLUSA preempted state claim? The *Dabit* Court stated that the requisite showing to activate SLUSA's preemption is "deception *in connection with the purchase or sale of any security*."[43] The second element to SLUSA's preemption, "in connection with the purchase or sale," is satisfied if the deception or fraud "'coincides' with a securities transaction."[44] Therefore, any class-action pleading that alleges a state claim involving 1) a deception 2) coinciding with a transaction involving covered securities is preempted by SLUSA. As preempted, the state claim must be dismissed. If the covered class has purchaser/seller "standing," generally the class can replead its claim so long as the pleadings conform to PSLRA's heightened federal security fraud pleading and appointment of lead plaintiff requirements.[45]

Given the opinion by a unanimous Supreme Court, it is hard to imagine that any state court class action that is related in any way to a transaction involving covered securities will not be preempted by SLUSA and removed to federal court. Indeed, even if the state court pleading does not specifically mention the word "securities," a defendant may prove SLUSA's preemption by asking the court to consider material that is "embraced by the pleadings . . . that are part of the public record."[46] The magnitude of the federal interest in protecting the national securities market cannot be overstated. SLUSA protects this interest by preventing its erosion from state class attempts to avoid federal securities laws. ■

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Endnotes

1. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,38 126 S. Ct. 1503, 1509 (2006).
2. *Id.* at 1506.
3. *Id.* at 1509.
4. *Id.*; 15 U.S.C. § 78j(b) (Section 10(b) of the 1934 Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe"); 17 C.F.R. § 240.10b-5 (2005) (Rule 10b-5 implements section 10(b) by declaring it unlawful, in connection with the purchase or sale of any security, "to employ any device, scheme, or artifice to defraud; to make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person").
5. *Dabit*, 126 S. Ct. at 1509 (implied right of private action under Rule 10b-5 was first recognized by a district court in 1946 and quickly adopted by an "overwhelming consensus of the District Courts and Courts of Appeals") (citations omitted).
6. *Id.* at 1509–10 (citing Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).
7. *Id.* at 1510.
8. *Id.* (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).
9. *Blue Chip Stamps*, 421 U.S. at 739.
10. *Dabit,* 26 S. Ct. at 1510 (citing H.R. Rep. No. 104-369, p. 31 (1995)).
11. *Id*. at 1510–11.
12. *Id.* at 1511; 15 U.S.C. §§ 78u-4(b), 78u5.
13. *Dabit*, 126 S. Ct. at 1511.
14. *See* Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 332 F.3d 116, 123 (2d Cir. 2003); Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 108 (2d Cir. 2001) ("[T]he decline in federal securities class action suits that occurred after the passage of [the] PSLRA was accompanied by a nearly identical increase in state court filings.") (citing H.R. Conf. Rep. No. 105-803)); *see also* SLUSA § (2), 112 Stat. at 3227.
15. *Lander,* 251 F.3d at 107.
16. 15 U.S.C. § 78bb(f)(1).
17. *Id.* at § 78bb(f)(5)(B).
18. *Id.* at § 78bb(f)(2); Kircher v. Putnam Fundsa Trust, 126 S. Ct. 2145, 2156 (2006) ("A covered action is removable if it is precluded, and a defendant can enlist the Federal Judiciary to decide preclusion, but a defendant can elect to leave a case where the plaintiff filed it and trust the state court (an equally competent body . . .) to make the preclusion determination.").
19. *Dabit*, 126 S. Ct. at 1507.
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.* at 1508.
26. *In re* Merrill Lynch & Co., Case No. 1:02cv1484, 2003 WL 1872820, *1 (S.D.N.Y. Apr. 10, 2003).
27. Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 51 (2d Cir. 2005).
28. *Dabit*, 126 S. Ct. at 1508.
29. *Id.*
30. *Id.* at 1508–09.
31. Kircher v. Putnam Funds Trust, 403 F.3d 478, 484 (7th Cir. 2005) (SLUSA is designed to prevent plaintiffs' effort to define nonpurchasers-nonseller classes to evade PSLRA to litigate a securities class action in state court in the hope that a local judge may produce an idiosyncratic award and holding SLUSA preempted state-court claims brought by mutual fund investors against funds for funds' alleged misconduct in setting prices, leaving funds vulnerable to exploitation by arbitrageurs); rev'd on other grounds, 126 S. Ct. 2145 (2006).
32. *Dabit*, 126 S. Ct. at 1513 (citing Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971); SEC v. Zandford, 535 U.S. 813, 820, 822 (2002)).
33. *Id.* at 1513 (citing United States v. O'Hagan*,* 521 U.S. 642, 651 (1997).

34. *Id.*

35. *Id.*

36. *Id.* at 1516 n.13 ("[W]e do not here revisit the *Blue Chip Stamps* Court's understanding of the equities involved in limiting the availability of private remedies under federal law; we are concerned instead with Congress' intent in adopting a pre-emption provision, the evident purpose of which is to limit the availability of remedies under state law.").

37. *Id.*

38. Jennifer O'Hare, *Preemption Under the Securities Litigation Uniform Standards Act: If It Looks Like a Securities Fraud Claim and Acts Like a Securities Fraud Claim, Is It a Securities Fraud Claim?,* 56 Ala. L. Rev. 325, 350 n.144 (2004) (citing Behlen v. Merrill Lynch, 311 F.3d 1087 (11th Cir. 2002); Winne v. Equitable Life Assurance Soc'y, 315 F. Supp. 2d 404 (S.D.N.Y. 2003); Cape Ann Investors LLC v. Lepone, 296 F. Supp. 2d 4 (D. Mass. 2003); Dacey v. Morgan Stanley Dean Witter & Co., 263 F. Supp. 2d 706 (S.D.N.Y. 2003); Kenneth Rothschild Trust v. Morgan Stanley Dean Witter & Co., 199 F. Supp. 2d 993 (C.D. Cal. 2002); Araujo v. John Hancock Life Ins. Co., 206 F. Supp. 2d 377 (E.D.N.Y. 2002); Zoren v. Genesis Energy, LP, 195 F. Supp. 2d 598 (D. Del. 2002); Gilmore v. MONY Life Ins. Co., 165 F. Supp. 2d 1276 (M.D. Ala. 2001); Prager v. Knight/Trimark Group, Inc., 124 F. Supp. 2d 229 (D.N.J. 2000); Lasley v. New England Variable Life Ins. Co., 126 F. Supp. 2d 1236 (N.D. Cal. 1999)).

39. *Id.* (citing Professional Mgmt. Assocs., Inc. Employees' Profit Sharing Plan v. KPMG, LLP, 335 F.3d 800 (8th Cir. 2003); Behlen v. Merrill Lynch, 311 F.3d 1087 (11th Cir. 2002); Dudek v. Prudential Sec., Inc., 295 F.3d 875 (8th Cir. 2002); Zoren v. Genesis Energy, LP, 195 F. Supp. 2d 598 (D. Del. 2002); Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 189 F. Supp. 2d 14 (S.D.N.Y. 2002); Gilmore v. MONY Life Ins. Co., 165 F. Supp. 2d 1276 (M.D. Ala. 2001); Prager v. Knight/Trimark Group, Inc., 124 F. Supp. 2d 229 (D.N.J. 2000)).

40. *Id*. (citing Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334 (11th Cir. 2002); Patenaude v. Equitable Life Assurance Soc'y, 290 F.3d 1020 (9th Cir. 2002); Cape Ann Investors LLC v. Lepone, 296 F. Supp. 2d 4 (D. Mass. 2003); Rowinski v. Salomon Smith Barney, Inc., No. 3:02CV2014, 2003 U.S. Dist. LEXIS 20918 (M.D. Pa. Nov. 20, 2003); Winne v. Equitable Life Assurance Soc'y, 315 F. Supp. 2d 404 (S.D.N.Y. 2003); Gray v. Seaboard Sec., Inc., 241 F. Supp. 2d 213 (N.D.N.Y. 2003); Feitelberg v. Merrill Lynch & Co., 234 F. Supp. 2d 1043 (N.D. Cal. Oct. 9, 2002); Kenneth Rothschild Trust v. Morgan Stanley Dean Witter, 199 F. Supp. 2d 993 (C.D. Cal. 2002); Prager v. Knight/Trimark Group, Inc., 124 F. Supp. 2d 229 (D.N.J. 2000)).

41. *In re* Oppenheimer Funds Fee Litig., 419 F. Supp. 2d 598, 596 (S.D.N.Y. 2006); *In re* Lord Abbett Mut. Funds Fee Litig., 407 F. Supp. 2d 616, 626–27 (D.N.J. 2005); LaSala v. Needham Co., Inc., 399 F. Supp. 2d 466, 474–75 (S.D.N.Y. 2005); *In re* Franklin Mut. Funds Fee Litig., 388 F. Supp. 2d 451, 471 (D.N.J. 2005); *In re* Mut. Funds Inv. Litig., 384 F. Supp. 2d 845, 872 (D. Md. 2005); Araujo v. John Hancock Life Ins. Co., 206 F. Supp. 2d 377, 384 (E.D.N.Y. 2002); *Winne*, 315 F. Supp. 2d at 417; *see also* Behlen v. Merrill Lynch, 311 F.3d 1087, 1095–96 (11th Cir. 2002).

42. Gray v. Seaboard Sec., Inc., 126 Fed. Appx. 14, 17 (2d Cir. 2005); Rowinski v. Salomon Smith Barney, Inc., 398 F.3d 294, 300 (3d Cir. 2005); Prof. Mgmt. Assoc., Inc. Employee's Profit Sharing Plan, 335 F.3d 800, 803 (8th Cir. 2003); *Behlen*, 311 F.3d at 1095–96; *In re* WorldCom, Inc. Sec. Litig., 308 F. Supp. 2d 236, 249 (S.D.N.Y. 2004); *In re* Enron Corp. Sec., Derivative & ERISA Litig., 284 F. Supp. 2d 511, 639 (S.D. Tex. 2003).

43. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1513 (2006).

44. *Id.*

45. *See* Dura Pharms., Inc. v. Broudo, 125 S. Ct. 1627, 1633 (2005) (security fraud complaints must specify each misleading statement, set forth the facts on which a belief that a statement is misleading was formed, and state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.); *see also* 15 U.S.C. §§ 78u-4(b)(1)-(4).

46. *In re* K-Tel Int'l, Inc. Sec. Litig., 300 F.3d 881, 889 (8th Cir. 2002); *see also* Cortex Indus., Inc. v. Sum Holdings, LP, 949 F.2d 42, 46–48 (2d Cir. 1991), *cert. denied*, 503 U.S. 960 (1992).

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