Legal Opinion Letter

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2009 Massachusetts Avenue, NW
Washington, DC 20036
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MERRILL LYNCH v. DABIT : THE SUPREME COURT EXAMINES SECURITIES FRAUD PREEMPTION

by
James Edward Maloney and Ryan D. McConnell

On January 18, 2006 the Supreme Court will hear arguments in *Merrill Lynch v. Dabit*, No. 04-1371. The Court has been asked to decide whether the Securities Litigation Uniform Standards Act (SLUSA) preempts state class actions based on allegedly fraudulent statements or omissions by plaintiffs who did not purchase or sell a security during the class period, but claim damages arising from merely *holding* a security. The Second Circuit held that such claims were not preempted. *Dabit v. Merrill Lynch, Pierce, Fenner, Inc.*, 395 F.3d 25 (2d. Cir. 2005). The Seventh Circuit has disagreed, noting that such an interpretation affords plaintiffs an end run around SLUSA *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005). The rift between the circuits turns on the meaning of the SLUSA's "in connection with a purchase or sale" language.

SLUSA was enacted in 1998 following the perception that post-Private Securities Litigation Reform Act (PSLRA) class actions were increasingly moving to state court to avoid the PSLRA reforms that made it more difficult for frivolous securities class actions to survive a motion to dismiss including heightened pleading standards and the safe harbor for forward looking statements. 15 U.S.C. §§ 77z-1(b), 78(u)-4(b). SLUSA mandates federal preemption for class actions for securities traded on a national exchange alleging misrepresentations or manipulation "in connection with the purchase or sale" of a security unless one of three exceptions applies. 15 U.S.C. § 78bb(f)(1). Both the Seventh and Second Circuits agree that the "in connection with a purchase or sale" tracks similar language used in Rule 10b-5, the federal securities laws' general antifraud provision. 17 C.F.R. § 240.10b-5. The circuits disagree, however, on how broadly this language should be read.

The Second Circuit *Dabit* case was a product of the New York Attorney General's investigation into conflicts of interests between research analysts and investment banks in 2002. The investigation uncovered evidence that research analysts were encouraged to tailor their reports to attract investment banking business. After the investigation surfaced, Shadi Dabit, a former Merrill Lynch broker, sued in federal court in Oklahoma on diversity grounds alleging that Merrill's actions violated state law. Dabit's complaint generally alleged that Merrill's research caused him to purchase and hold various securities and lose clients for whose accounts the purchases were made. After these claims were dismissed as preempted by SLUSA, Dabit amended his complaint by including the language "owning or holding" and deleting numerous references to "purchases." IJG Investments filed a similar action in Minnesota state court alleging that Merrill provided biased investment advice in violation of its contact with IJG. IJG defined its class to include those who paid commissions or fees to Merrill. Merrill removed the IJG case to federal court. Both cases along with over a 100 others were coordinated by the Multidistrict Litigation Panel in the Southern District of New York. The district court dismissed both of the cases because the state law claims were preempted by SLUSA. *See Dabit*, 395 F.3d 29-31.

James Edward Maloney is a partner and **Ryan D. McConnell** is an associate at the law firm Baker Botts L.L.P. in the firm's Houston office.

On appeal, the Second Circuit reversed in part and affirmed in part. *Id*. at 51. First, the court noted that in evaluating a motion to dismiss on SLUSA preemption grounds a court must "look beyond the face of the complaint to analyze the substance of the allegations made." *Id*. at 34. In doing so, it held that Dabit's claim of "'holding' damages related to Merrill Lynch's fraudulent inducement of Dabit to retain certain securities" and IJG's claim for commissions paid to Merrill were properly dismissed as preempted by SLUSA. These claims, implicitly or explicitly, involved the purchase or sale of a security. *Id.* at 44-48. The court, however, disagreed with the district court on the claims that involved no purchase or sale such as Dabit's claim for lost brokerage commissions for customers who left Merrill after the research allegations surfaced or IJG's claim that it overpaid for the biased research. It held that these "holder" claims are not covered by SLUSA because the phrase "in connection with the purchase or sale" is limited by the Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 726 (1975) to purchasers and sellers and Congress knew of this limitation when it employed the language in SLUSA. *Id*. at 28. In *Blue Chip* the Supreme Court adopted the purchaser or seller requirement for a private plaintiff seeking to maintain an action under Section 10. The Second Circuit could find nothing in either the legislative history or SLUSA itself to contradict this interpretation. *Id*. For the Second Circuit, after accepting that the "in connection with the purchase or sale" language in SLUSA tracks that found in 10b-5, *Blue Chip*'s purchaser or seller limitation becomes an inescapable conclusion.

In *Kircher*, the Seventh Circuit had difficulty marrying SLUSA and *Blue Chip*. *Kircher* involved plaintiffs who sought to skirt SLUSA by defining their class as holders of mutual fund shares who neither purchased nor sold during the class period. *Id*. at 483. This creative pleading did not pass muster. The court held that SLUSA preemption applied broadly and included holders as well as purchasers and sellers. After noting that the Eighth, Eleventh, and Second Circuits had found SLUSA preemption linked to the coverage of 10b-5 actions, the court held that the Supreme Court had never limited the "in connection with a purchase or sale" language to purchasers or sellers outside of the context of standing in a private action. *Id*. The court stated that, to the contrary, "[i]t 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 laws or not at all." *Id*. at 484. One of the risks with this view is that plaintiffs who have been injured by holding a security are left with no private remedy. The court pointed out, however, that the interests of these holders could be vindicated by the government. It concluded, "[b]y depicting their classes as containing entirely non-traders, plaintiffs do not take their claims outside § 10(b) and Rule 10b-5; instead they demonstrate only that the claims must be left to public enforcement." *Id.*

If *Dura Pharm., Inc., v. Broudo*, 125 S. Ct. 1627 (2005) is any guide to what the Supreme Court may do, a reversal of the Second Circuit's decision is likely. In *Dura* the Supreme Court noted that the Ninth Circuit's price inflation theory was inconsistent with the objectives of the PSLRA. 125 S. Ct. at 1633. Justice Breyer wrote that the Ninth Circuit's view undermines the PSLRA by "permit[ing] a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence.'" *Id.* at 1634 (citing *Blue Chip*, 421 U.S. at 741.) In *Dabit* the Supreme Court will likely read SLUSA in a way that ensures that the PSLRA's objectives are met. Otherwise, the Court may fear that if the phrase "in connection with the purchase or sale" is read to exclude holders many judges may not look closely enough at the complaint to weed out artfully pleaded holder claims to ensure plaintiffs are not simply attempting to avoid the PSLRA's mandates. Even the Second Circuit noted SLUSA was part of a broader scheme to achieve national uniformity for "class action litigation involving our national capital markets." *Dabit*, 395 F.3d at 41 n. 10. The Court will likely recognize this goal and read SLUSA broadly. *See* STEPHEN BREYER, ACTIVE LIBERTY 85-101 (2005) (advocating statutory interpretation that furthers overarching legislative objectives).

Empirically, it is difficult to say how many cases represent true holder cases and not merely artful pleading that can be ferreted out by, as the Second Circuit suggests, looking beyond the allegations in the complaint. Both the Second Circuit and the Seventh Circuit realized that the complaints in their respective cases had been carefully crafted to slip into the perceived exception for holders of securities who did not purchase or sell during the class period. Indeed, both courts dismissed these claims. In the Second Circuit, this left only the claims of lost brokerage commissions and over payments for Merrill's research. *Dabit*, 395 F.3d at 47, 48. The Supreme Court should let us know this term whether these plaintiffs need to go back to the drawing board.

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