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High Court Clarifies 'In Connection With' Preemption Under SLUSA

A recent U.S. Supreme Court decision, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 US —, 2006 WL 694137 (March 21, 2006), clarifies that the scope of federal preemption under the Securities Litigation Uniform Standards Act of 1998 (SLUSA) is broader than the U.S. Court of Appeals for the Second Circuit had concluded last year.

Reversing the Second Circuit's decision in *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F3d 25 (2d Cir. 2005), the Supreme Court unanimously held that the phrase "in connection with the purchase or sale of a covered security," as used in SLUSA, must be read to encompass all claims in which a misrepresentation or manipulation coincides with a purchase or sale of securities, not only claims made by a purchaser or seller. Thus, covered class actions by holders of securities who did not purchase or sell are preempted, even though those holders would not meet the standing requirement to sue under §10(b) of the Securities Exchange Act. Litigants and courts should now reassess pending cases in light of this broad preemption and move to dismiss cases or claims which were previously thought to avoid SLUSA's preemptive reach.

SLUSA

SLUSA was enacted to remedy an unintended consequence of the Private Securities Litigation Reform Act of 1995 (Reform Act), which made securities fraud pleading standards more stringent. 15 USC §§77z-1(b), 78u-4(b). As class action plaintiffs acted to avoid the heightened federal pleading standards by bringing their suits in state courts under state statutory or common law, Congress discerned a "federal flight" problem. SLUSA was enacted to stem this shift to state courts

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and to prevent certain state actions alleging either misrepresentation or omission of a material fact or the use of a manipulative device from being used to frustrate the objectives of the Reform Act. It made federal courts the exclusive venue, and federal law the exclusive law, for class actions making those allegations in connection with the sale of covered securities. *Merrill Lynch*, 2006 WL 694137 at *6-7; *Dabit*, 395 F.3d at 32-33.

SLUSA provides that no "covered class action"—i.e., one in which damages are sought on behalf of more than 50 persons—based upon state law may be maintained in any court by any private party alleging misrepresentation or manipulation "in connection with the purchase or sale of" a security covered by the Securities Act. 15 USC §78bb(f)(1); see *Merrill Lynch*, 2006 WL 694137 at *7. Any covered class action may be removed to federal court; but if the federal court determines that the action may be maintained in state court, then it must be remanded. Id. §78bb(f)(2), (3)(D). The standard for preemption rests on the identical "in connection with" test. Id. §78bb(f)(2).

The Second Circuit Decision

The *Dabit* action was brought by a former Merrill Lynch broker, complaining of Merrill Lynch's allegedly biased research and investment recommendations and alleging breaches of fiduciary duty and the covenant of good faith and fair dealing on behalf of all Merrill Lynch brokers who held the recommended securities. 395 F3d at 29. At issue was whether the action, which involved claims of persons who merely held, but did not themselves purchase or sell, securities, was preempted by federal law because it alleged claims of misrepresentation or manipulation "in connection with" the purchase or sale of securities under SLUSA. Judge Milton Pollack held that it was preempted, and dismissed the action. 2003 WL 1872820 (SDNY 2003).

The Second Circuit disagreed, concluding that only claims that were viable under §10(b) were preempted. 395 F3d at 47, 50. In the court's view, the "in connection with" language of SLUSA should be read to reach the same conduct as §10(b), so that it will preempt precisely those state class actions that could be brought as federal actions and not preempt actions that would not meet the §10(b) requirements. Id. at 36. Although recognizing that Congress presumably intended to apply the extensive body of case law interpreting the "in connection with" language under §10(b) when it used the same language in SLUSA, id. at 34-36, the Second Circuit believed that would include an intention to import the purchaser-seller standing rule of *Blue Chip Stamps v. Manor Drug Stores*, 421 US 723 (1975). Id. at 39-40, 43. In *Blue Chip*, the Supreme Court restricted the private Rule 10b-5 remedy to actual purchasers or sellers of securities. This rule precluded claims that a defendant's fraud caused the plaintiff not to act, supported only by the plaintiff's own self-serving testimony. *Dabit*, 395 F3d at 38 (citing *Blue Chip*, 421 U.S. at 733).

Thus, the Second Circuit concluded that only actions by purchasers or sellers were preempted by SLUSA. Id. at 43. A later U.S. Court of Appeals for the Seventh Circuit decision reached a contrary conclusion, ruling that "holding" claims asserted under state law were preempted because the SLUSA "in connection with" language should be interpreted as broadly as it is under §10(b), to cover any case where "the

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fraud occurs in securities transactions rather than some other activity," and should not be limited by the distinct *Blue Chip* purchaser or seller standing requirement. *Kircher v. Putnam Funds Trust,* 403 F3d 478, 483 (7th Cir. 2005). This set the stage for the Supreme Court's resolution of the issue.

The Supreme Court Decision

Justice John Paul Stevens issued an opinion on behalf of a unanimous Supreme Court (without Justice Samuel Alito), reversing the Second Circuit. 2006 WL 694137 at *2. The core issue was whether the "in connection with" preemption language of SLUSA should be construed to incorporate the standing requirement of *Blue Chip,* as the Second Circuit had held, thereby preempting only those class actions asserting claims by purchasers or sellers. The Supreme Court rejected that view, instead holding that the background, text, and purpose of SLUSA's preemption provision all support the broader interpretation adopted by the Seventh Circuit. Id. On that analysis, any claim that qualifies under the substantive "in connection with" principles is preempted, regardless of whether the litigant could successfully assert such a claim under §10(b) due to his status as a non-purchaser or non-seller. Id. at *7.

Like the Second Circuit, the Supreme Court looked to what Congress must have intended when it used the "in connection with" language in SLUSA, but concluded, as the Seventh Circuit had in *Kircher,* that the use of that term did not import the *Blue Chip* purchaser/seller restriction. Justice Stevens reviewed the historical development of the *Blue Chip* rule, explaining that it came about in 1975 only as a judicially crafted limitation upon a judicially created private right of action under §10(b) and Rule 10b-5. The *Blue Chip* standing rule was not compelled by a substantive analysis of the "in connection with" language in Rule 10b-5, but was based principally on policy considerations. Recognizing that claims made under Rule 10b-5 presented a great danger of vexatious litigation and frustration or delay of normal business activity, the Court chose to limit the implied private remedy to purchasers and sellers as a means of minimizing those potential ill effects. (The limitation had no effect on government enforcement actions.) 2006 WL 694137 at *4-5. The Reform Act was motivated by similar policy considerations, and the goal of SLUSA was to prevent frustration of the Reform Act's objectives. Id. at *6.

In contrast, Justice Stevens observed, the Court has espoused a broad interpretation of the "in connection with" language. Under its cases, including most recently *SEC v. Zandford,* 535 US 813 (2002), "it is enough that the fraud alleged 'coincide' with a securities transaction— whether by the plaintiff or by someone else." In other words, he said, the requisite showing is deception in connection with the purchase or sale of any security, not deception of an identifiable purchaser or seller. Id. at *7. Congress must have been aware of this broad construction, which had been adopted by the Supreme Court in pre-*Zandford* cases (and also by the SEC), when it imported the "in connection with" phrase into SLUSA in 1998. Id. at *8.

Further, Justice Stevens reasoned, a narrow reading of the preemption statute is undesirable because it would: (1) undercut the goals of the Reform Act and SLUSA to reduce vexatious securities litigation; (2) exempt from SLUSA's preemptive sweep the very holder claims that the *Blue Chip* Court found "particularly troublesome;" and (3) promote duplicative parallel litigations on the same or similar facts and undercut Congress' goal of ensuring national standards for class actions involving nationally traded securities. Justice Stevens also noted that SLUSA does not actually preempt any state law cause of action, but merely denies the use of the class action vehicle, and carefully carved out exceptions which makes it inappropriate for courts to create additional implied exceptions. Id. at *9.

The Effect of 'Merrill Lynch'

The Supreme Court's decision clarifies that, in the context of the SLUSA preemption analysis, it does not make any difference whether the class litigants' claims would be viable under §10(b). Even holding claims that cannot be asserted under federal law are preempted if they coincide with securities transactions. This construction of SLUSA does not necessarily deny litigants any remedy at all, as they can still assert state claims on an individual basis (they are barred only from using the class action device for 50 or more persons), and the SEC retains enforcement powers to address holding claims. But it does mean that plaintiffs cannot frame their allegations as holder claims as an expedient to preserve them under state law.

As a result of this decision, not only will more state-law claims be found to be preempted, but a number of courts and litigants may need to reassess their pre-existing assumptions and decisions. In addition to the Second Circuit, at least two other circuits and a number of district courts had considered the preemption scope to be coextensive with the purchaser/seller standing rule and thus, claims by holders were not preempted. See, e.g., *Riley v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 292 F3d 1334, 1345 (11th Cir. 2002); *Green v. Ameritrade, Inc.,* 279 F.3d 590, 597-99 (8th Cir. 2002). State law claims pendent to federal securities law claims, as well as state law claims pending in state court, that were previously allowed to proceed due to the perceived limited scope of SLUSA preemption, should be dismissed. Such claims pending in state court may be removed to federal court and dismissed under SLUSA, despite the 30-day limitation found in the federal removal provision, 28 USC §1446(b), and without regard to any prior such removal and remand under a different interpretation of the scope of SLUSA preemption.

As an instructive example, in *Bradfisch v. Templeton Funds,* an Illinois district court had remanded a class action brought by holders to state court in 2004. 319 FSupp2d 897 (S.D. Ill. 2004). In 2005, following the Seventh Circuit's ruling in *Kircher,* the defendants again removed the case. This time the federal court found that the action was preempted under SLUSA and dismissed the case. 2005 WL 1653798 (S.D. Ill. July 12, 2005). While removal would not have been permissible under 28 USC §1446(b), SLUSA itself provides for removal without any time limitation (15 USC §§77p(c), 78bb(f)(2)), and mandates dismissal in appropriate cases.

Conclusion

The *Merrill Lynch* decision will force some courts and litigants to reconsider their previous assumptions and decisions on SLUSA preemption. Class action claims which previously were thought to have a forum as state law claims where no private federal securities law relief was available, will now have no forum at all. This decision will advance SLUSA's objectives of preventing class action litigants from evading the Reform Act's strictures and ensuring uniform national standards.