Congress passed legislation designed to curb “abusive” shareholder class actions brought in federal courts. When plaintiffs began moving their class actions to state courts, Congress responded by passing legislation allowing defendants to remove from state court to federal court certain class actions brought “in connection with the purchase or sale of a covered security.” Since then much litigation has ensued over the coverage of this removal statute, leading to a split among the circuits. Some circuits have given the statute broad coverage, thus limiting attempts to move securities class actions out of federal court. Other circuits—such as the Second Circuit—have given the statute a narrower reading. On September 27, 2005, the Supreme Court moved to resolve the split by granting review of Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25 (2d Cir. 2005).

**Background**
Congress enacted the Private Securities Litigation Reform Act of 1995 (“PSLRA”) to curb abusive shareholder class actions. The PSLRA enacted a number of reforms, including heightened pleading standards and mandatory stays of discovery, but it reached only securities class actions filed in federal court.

The plaintiffs’ bar responded to the PSLRA by filing suits in state courts under state law, thereby circumventing the PSLRA. Congress responded by enacting the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”).

SLUSA is designed to prevent plaintiffs from migrating to state court by making federal courts the exclusive forum for class actions alleging fraud in the sale or purchase of a “covered security.” To that end, SLUSA preempts “covered” class actions “based upon the statutory or common law of any State or subdivision thereof . . . [initiated] 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.” 15 U.S.C. § 78bb(f)(1)(A). Because SLUSA prohibits class actions based on state or common law, such actions, once removed to federal court, are subject to immediate dismissal.
To invoke SLUSA, a defendant seeking to remove a case to federal court must show: (1) that the action is a “covered class action”; (2) that the action purports to be based on state law; (3) that the defendant is alleged to have misrepresented or omitted a material fact (or to have employed a manipulative device or contrivance); and (4) that the defendant’s alleged conduct was “in connection with the purchase or sale of a covered security.” 15 U.S.C. §§ 78bb(f)(1)-(2); Green v. Ameritrade, Inc., 279 F.3d 590, 596 (8th Cir. 2002).

SLUSA does not define the phrase “in connection with the purchase or sale of a covered security.” This phrase quickly became the battleground between those favoring a broad reading of SLUSA (typically defendants) and those favoring a narrow reading of SLUSA (typically plaintiffs).

Circuits Split Defining “In Connection With” as Applied to Holders of Securities

The Second, Eighth and Eleventh Circuits have each interpreted SLUSA to cover only sellers and purchasers of securities, and not holders. The Seventh Circuit, on the other hand, recently rejected two attempts by plaintiffs to plead around the “in connection with” language by limiting their classes to holders of securities.

Since Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), it has been the rule that one cannot state a claim under the federal securities law by alleging that the putative fraud caused one to hold a security, as opposed to buy or sell a security. Holders thus have a remedy (if at all) only under state law. Seizing on this principle, plaintiffs in all these cases have attempted to plead around SLUSA by limiting the claimants to holders.

The Second Circuit’s ruling in Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25 (2d Cir. 2005) follows the lead of the Eighth and Eleventh Circuits in Green v. Ameritrade, Inc., 279 F.3d 590 (8th Cir. 2002) and Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334 (11th Cir. 2002). Dabit arose out of the investigation into securities analysts who allegedly touted certain stocks to gain the issuers’ investment banking business. The plaintiffs, a former Merrill Lynch broker and a former Merrill Lynch customer, alleged that they had held stocks and lost commissions (the broker) or paid commissions (the customer) because of bad advice said to be given in violation of state law. 395 F.3d at 34. The sole question on appeal was whether the alleged misrepresentations were made “in connection with the purchase or sale” of covered securities for purposes of SLUSA. Id. Noting that SLUSA did not define the phrase and the Supreme Court had not interpreted the phrase in the context of SLUSA, the court, in an opinion by Judge Sotomayor, accepted the meaning given to it in Blue Chip. Id. at 35-36. The court held that because only purchasers and sellers have a federal private damages remedy, and because the “in connection with” language had a “settled, and widely-acknowledged, meaning in the field of securities law,” “Congress sought only to ensure that class actions brought by plaintiffs who satisfy the Blue Chip purchaser-seller rule are subject to the federal securities laws.” Id. at 35-36, 43. The court reasoned that Blue Chip’s bar on private claims by holders was “counterbalanced by the existence of remedies under state law.” Id. at 40. The court said this interpretation did justice to Congress’ stated intent of closing the “federal flight loophole” (id. at 32, 36, 42, 47) by stemming the migration to state courts of claims capable of being pursued in federal courts. Interestingly, the court asked for the SEC’s opinion on the matter and then largely rejected it.
The Seventh Circuit disagreed with Dabit in two recent decisions, setting up the circuit split. In Kircher v. Putnam Funds Trust, 403 F.3d 478 (7th Cir. 2005), the plaintiffs charged mutual funds with setting prices in a way that arbitrageurs could exploit, and they limited their class to investors who held mutual fund shares between specified dates. Id. at 480, 482. They argued that their claims did not arise “in connection with the purchase or sale of a covered security” and thus were not covered by SLUSA. The Seventh Circuit, in an opinion by Judge Easterbrook, rejected this argument, noting that 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.” Id. at 484. Instead, the court said that “the ‘in connection with’ language ensures that the fraud occurs in securities transactions rather than some other activity.” Id. at 483. Accordingly, it held 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.” Id. at 484.

In Disher v. Citigroup Global Markets Inc., 419 F.3d 649 (7th Cir. 2005), much like Dabit, the plaintiffs alleged they were induced to hold securities in reliance on the misleading advice of the defendant’s stock analysts. Id. at 651. The plaintiffs defined their class as all customers who retained certain securities in reliance on defendant’s misrepresentations, and specifically excluded “any claims based on [defendant’s] conduct in connection with . . . any Class member’s purchases or sales of any [stocks].” Id. Nonetheless, the Seventh Circuit held that the claims were “connected sufficiently to the purchase and sale of a covered security for the purposes of SLUSA preemption and removal.” Id. at 655. Accordingly, the court ordered the case be dismissed. Id.

Conclusion
The lines have been drawn. It is now up to the Supreme Court to determine whether or not SLUSA covers claims asserted by securities holders in state courts, and will therefore mandate their dismissal. By next summer we should know.

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