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March 30, 2006

The Supreme Court Applies SLUSA Federal Pre-Emption State Court Securities "Holder" Class Actions

In *Merrill Lynch, Pierce Fenner & Smith, Inc.* v. *Shadi Dabit*, No. 04-1371 (U.S. Mar. 21, 2006) ("*Dabit*") (an 8-0 decision, opinion by Justice Stevens[1]), the Supreme Court extended the "primacy" of the federal securities laws with respect to class actions involving nationally traded securities by ruling that the pre-emption provisions of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") apply to class actions under state law brought on behalf of persons who neither purchased or sold, but who allegedly were induced to continue to hold, such securities in reliance on an material misrepresentation or omission ("holder class actions"). In so holding, the Court made clear that "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated." (slip op. at 5). *Dabit* is notable for several reasons.

First, in discussing the history of the implied private right of action under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") and SEC Rule 10b-5 promulgated thereunder, the Court emphasized its earlier recognition in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), that 10(b)/10b-5 litigation presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general. *See* slip op. at 8.

Second, the Court found that policy considerations similar to those that supported the Court's decision in *Blue Chip Stamps* prompted Congress in 1995 to adopt the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), and that the filing of state law holder class actions was an unintended consequence of the enactment of SLUSA and constituted an attempt at an end run around it and the PSLRA. *See* slip op. at 9, 13.

Third, the Court spoke to the "in connection with" requirement of Section 10(b) and Rule 10b-5, stating that "[u]nder our precedents, it is enough that the fraud alleged 'coincide' with a securities transaction — whether by the plaintiff or by someone else. . . . 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.'" (slip op. at 12-13) (citation omitted).

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[1] Justice Alito took no part in the consideration or decision in the case.

Dabit is the first federal securities law decision by the Roberts Court, and suggests that future decisions in this area will be policy-driven, with emphasis on Congressional intent.

SLUSA and its Intended Purpose

SLUSA, which constitutes an amendment to and is a part of the 1934 Act, provides that "[n]o covered class action" based on state law and alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" "may be maintained in any state or federal court by a private party." SLUSA provides for the removal of actions containing such claims to federal district court where, if they meet the foregoing criteria, dismissal is required by the express statutory language. If the foregoing criteria are not satisfied, the district court is required to remand the case to the state court.

The key terms under SLUSA are (i) "covered class action"; (ii) "covered security" and (iii) "in connection with the purchase or sale."[2] The first and second of these terms are defined in SLUSA. The phrase "in connection with the purchase or sale" is not defined in SLUSA or elsewhere in the 1934 Act.

In 1995, the PSLRA amended the 1934 Act to require that a claim alleging fraud under Section 10(b) of the 1934 Act, and particularly one brought on "information and belief" (as most such class actions purport to be) must state with "particularity" sufficient "facts" to support a reasonable belief that a defendant's statement was misleading when it was made. 15 U.S.C. § 78u-4(b)(1). Section 78u-4(b)(2) of the PSLRA requires that allegations of *scienter*, an element of a Section 10(b) claim, be supported by "particularized" "statements" of "fact" giving rise to a "strong inference" of *scienter*. As the Court observed in *Dabit*, "[r]ather than face the obstacles set in their path by the Reform Act, Plaintiffs and their representatives began bringing [securities] class actions under state law, often in state court." (Slip op. at 9-10) This is the loophole that SLUSA was intended to plug.

The Lower Court Opinions in *Dabit*

Shadi Dabit is a former Merrill Lynch broker. After an amendment of his complaint which eliminated all reference to "purchasers," his class action was asserted on behalf of all former or current brokers of Merrill Lynch who "owned and continued to own" certain stocks, alleging breach by Merrill Lynch of fiduciary duties and the covenant of good faith and fair dealing owed to its brokers by disseminating misleading research and manipulating stock prices. Dabit claimed that he and the other Merrill Lynch brokers relied on overly optimistic Merrill Lynch research reports in deciding not to sell their subject holdings beyond the point when, had the alleged truth been known (*i.e.*, that the research reports were fabricated to increase Merrill Lynch's investment banking business), they would have sold the

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2 SLUSA specifically exempts, *inter alia*, (i) "Actions under state law of state of incorporation" (the "Delaware carve-out"); (ii) exclusively derivative actions; (iii) class actions involving less than 50 persons.

There is a split in authority as to whether SLUSA applies to claims alleging mere inaccuracy brought in state court under the Securities Act of 1933 ("1933 Act") with the majority of cases holding that such actions are not removable.

securities. The class thus claimed damages as a result of "holding" shares, not as a result of purchasing or selling them.

The *Dabit* complaint alleged violation of Oklahoma state law only, but was filed in federal court on the basis of diversity of jurisdiction. The case was transferred to the Southern District of New York by the Judicial Panel on Multidistrict Litigation and consolidated for pre-trial purposes with other cases involving the optimistic Merrill Lynch research reports before Judge Milton Pollack. Judge Pollack dismissed Dabit's holder class claims as falling "squarely within SLUSA's ambit." The Second Circuit disagreed, holding that the phrase "in connection with the purchase or sale of securities" in SLUSA was intended by Congress to incorporate the "standing" limitation of *Blue Chip Stamps*, which held that claims by persons who neither purchased nor sold securities do not have standing to assert claims under Section 10(b) of the 1934 Act. The Second Circuit concluded that if the alleged fraud was not asserted by a purchaser or seller it could not be asserted under federal law, and if permitted under state law was not pre-empted by SLUSA.

The Supreme Court's Decision in *Dabit*

The *Dabit* decision explained that the Court's decision in *Blue Chip Stamps* relied "principally on 'policy considerations'", specifically "the widespread recognition that 'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general. . . . Even weak cases brought under the Rule may have substantial settlement value because '[t]he very pendency of the lawsuit may frustrate or delay normal business activity'" (slip op. at 11-12). *Dabit* further explained that these same policy considerations prompted Congress to enact the PSLRA which was "targeted at perceived abuses of the class action vehicle in litigation involving nationally traded securities" (slip op. at 8).

The Court observed that a narrow reading of the phrase "in connection with the purchase or sale of a covered security" under SLUSA "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 from being used to frustrate the objectives' of the 1995 Act" (slip op. at 14). The Court noted that a contrary holding would result in "parallel class actions proceeding in state and federal court, with different standards governing claims asserted on identical facts" (*Id*.).

The Court interpreted its holding in *Blue Chip Stamps* as pertaining to the question of standing — "the scope of a private right of action under Rule 10b-5" — and "not to define the words 'in connection with the purchase or sale'" (slip op. at 12). While the identity of the plaintiff as a purchaser, seller or mere holder, may well dictate whether standing requirements are satisfied, "the identity of the plaintiffs does not determine whether the complaint alleges fraud 'in connection with the purchase or sale' of securities." (slip op. at 16).

The Court observed that it has always given a broad interpretation to the phrase "in connection with the purchase or sale of securities," and that Congress must have been aware of this broad interpretation of the phrase as it appeared in the 1934 Act when the same phrase was included in SLUSA, also a part of the 1934 Act (slip op. at pp. 11-12).

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If you have any questions about the issues presented in this memorandum or you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Charles Gilman at (212) 701-3403 or cgilman@cahill.com; Leonard Spivak at (212) 701-3203 or lspivak@cahill.com; Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.