Merrill Lynch v. Dabit: The Case of the Scorned Broker and the Death of the State Securities Fraud Class Action Suit

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Repository Citation
Available at: https://digitalcommons.law.lsu.edu/lalrev/vol67/iss1/9
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I. INTRODUCTION

In a news conference on Tuesday, April 8, 2002, New York Attorney General Eliot Spitzer announced that his office had been conducting a nine month investigation into an investment analysis conducted by Merrill Lynch analysts. Spitzer alleged that Merrill Lynch analysts had produced misleadingly positive assessments of stocks so that the investment banking arm of Merrill Lynch could secure fees from selling stock and advising on mergers. The New York Attorney General pointed to Merrill Lynch email messages that referred to the same stocks subject to rosy assessments as "piece[s] of junk" and "powder keg[s] as evidence to support his accusations." At the time of the announcement, Wall Street observers hinted that conflicts of interest and biased recommendations permeated the entire industry. Indeed, approximately one month later Spitzer announced that he had expanded the scope of his investigation to include Switzerland’s UBS AG and Credit Suisse Group. Merrill Lynch quickly negotiated a $100 million settlement with Spitzer that outlined a series of reforms designed to eliminate the alleged conflicts of interest. Other Wall Street investment banks mimicked the

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2. Tom Incantalupo, Spitzer: NY to Probe Other Securities Firms, NEWSDAY, Apr. 9, 2002, at A45.
3. Id. These emails allegedly were written by the infamous Merrill Lynch security analyst Henry Blodget. Michael Gormley, Merrill Talks to Get More Time, GLOBE & MAIL, May 8, 2002, at B13.
4. Incantalupo, supra note 2.
5. Gormley, supra note 3.
6. Id.
reforms outlined in the settlement, including Credit Suisse First Boston.

The damage, however, was already done. Shadi Dabit, a former Merrill Lynch broker, filed a class action suit against his former employer alleging breach of fiduciary duty and the covenant of fair dealing on behalf of current and former Merrill Lynch brokers. Dabit pointed to Merrill Lynch’s misleading analyst reports as the cause for his and his clients’ decision to hold their securities beyond the point when they would have sold had they known the truth. Rather than relying on federal securities law, Dabit anchored his claim on Oklahoma state law which, according to Dabit’s interpretation, recognized a securities fraud holding claim.

Dabit’s choice was shrewd given the changing legal landscape of private securities fraud class action suits. Compared to state regulation, federal securities law imposes strict jurisprudential standing requirements and heightened pleading standards. Conversely, state securities regulation is less stringent given that some states recognize securities fraud holding claims, which are grounded in tort theories of fraudulent inducement. Nevertheless, the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) stands as a formidable obstacle to the viability of state securities fraud claims. If a court determines that the plaintiffs’ state law holding claim falls within SLUSA’s

8. Id.
9. See discussion infra Parts II.A-B.
10. Securities fraud holding claims are made by shareholders who allege that they were induced not to sell their securities. See infra notes 35–40 and accompanying text for a discussion of these state claims. By their very definition, such claims do not satisfy standing requirements established with regard to a private right of action inferred under Section 10(b) and Rule 10b-5. See infra notes 16–34 and accompanying text for a detailed discussion of the federal securities laws and Section 10(b).
11. This idea is synonymous with “fraud in the inducement” or “fraud occurring when a misrepresentation leads another to enter into a transaction with a false impression of the risks, duties, or obligations involved.” BLACK’S LAW DICTIONARY 686 (8th ed. 2004). See infra Part II.B for a discussion of this tort theory and its relationship with state securities laws.
preemptive scope, the statute functions to invalidate the plaintiffs’ state law claim.12 Once the action is removed to federal court, the plaintiffs’ cause of action is dismissed altogether since federal securities law does not recognize analogous holding claims. Prior to the United States Supreme Court’s decision in Dabit, a split had emerged among the federal courts of appeals regarding whether SLUSA’s preemptive scope reached class action suits premised on state securities fraud holding claims. The Supreme Court resolved this conflict among the federal appellate circuits in March of 2006 when it held that SLUSA preempts state securities fraud holding claims.13

In a time where forty-one percent of investors identify “dishonesty” as the main issue facing the securities industry14 and defrauded shareholders may expect to receive only around six percent of their claimed losses against even solvent companies,15 it is an appropriate moment to reevaluate the regulatory state of the securities markets and explore legal methods to restore investor confidence. This casenote addresses the extent to which state law holding claims fall within SLUSA’s preemptive scope. Part II examines the background of the federal securities law, Congress’s recent efforts to amend the original SEC Act, and the specific provisions in SLUSA. Part III of this casenote considers federal circuit decisions concerning SLUSA preemption of state law holding claims and identifies the majority and minority rules that have resulted from a split among the circuits. Finally, Part IV addresses the United States Supreme Court’s opinion in Merrill Lynch v. Dabit, which recognized that SLUSA’s preemptive scope reaches securities fraud holding claim class action suits. Furthermore, Part IV also examines some remaining questions surrounding SLUSA, including whether the statute should be construed as a statute of complete preemption and whether the

12. See discussion infra Part II.C.3.
Court's interpretation of SLUSA has any collateral impact on the SEC's enforcement authority.

II. FEDERAL AND STATE SECURITIES LAWS AND CONGRESS'S BLURRING OF THE LINES

To appreciate the magnitude of Congress's action in passing SLUSA in 1998, it is important to understand the relationship between the federal and state regimes prior to 1998. Congress intended to supplement and reinforce state securities laws when it first enacted the 1933 and 1934 Acts. However, after recent federal legislative steps, federal and state securities laws have existed in an increasingly precarious dichotomy. This Part discusses the background regarding SLUSA preemption of state securities fraud holding claims by examining the federal securities laws and the implicit private right of action under Section 10(b) and Rule 10b-5, the various common law theories that have been used in state courts for securities fraud, and Congress's most recent legislative steps to shift the balance between federal and state securities fraud causes of action.

A. Federal Securities Laws and Section 10(b)

Although the Securities and Exchange Act of 1934 does not explicitly provide a private right of action for securities fraud, Section 10(b) of the 1934 Act has been judicially interpreted to provide such a private right of action. The language of Section 10(b) provides that "[i]t shall be unlawful for any person . . . 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 Commission may prescribe." A private right of action under Section 10(b) was judicially inferred as early as 1946. Given its unique

jurisprudential origin, the private right of action under Section 10(b) of the 1934 Securities Exchange Act has been appropriately described as a "judicial oak that has grown from a legislative acorn."¹⁹

Because a private right of action under the 1934 Act has been judicially inferred, the United States Supreme Court has taken steps to restrict the use of Section 10(b) as a private remedy. The Court adopted the purchaser/seller standing rule in its decision in Blue Chip Stamps v. Manor Drug Stores as a means of restricting the circumstances in which plaintiffs could use Section 10(b) as a private cause of action.²⁰ The plaintiff in Blue Chip Stamps alleged that he and the other members of the class failed to purchase shares issued by Blue Chip Stamp Co. as part of a reorganization plan due to their reliance on a false and misleading prospectus.²¹ Before the Court reached its final disposition of the case, it recited the history of the standing rule. The purchaser/seller standing rule was born of a Second Circuit opinion written by Judge Augustus Hand that reasoned since both Section 10(b) and Rule 10b-5 addressed fraud "in connection with the purchase or sale" of covered securities, the plaintiff class in a Rule 10b-5 private action was limited to actual purchasers and sellers.²² In adopting the purchaser/seller standing rule, the Court found that such a limitation on the plaintiff class would avoid the use of Section 10(b) as a private tool for vexatious or strike suits²³ and would thus promote judicial economy.²⁴ The Court, however, was careful to explicitly state that the purchaser/seller standing requirement in regard to private rights of action was not required

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20. Id. at 749.
21. Id. at 727.
22. Id. at 730–31 (citing Birnbaum v. Newport Steel Corp. 193 F.2d 461, 463–64 (2d Cir. 1952)).
23. Id. at 739–40. A strike suit is defined as "a suit, often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement." Black's Law Dictionary 1475 (8th ed. 2004).
24. Blue Chip Stamps, 421 U.S. at 742–43. Regarding judicial economy, the Court reasoned that a plaintiff's failure to satisfy the standing requirement would be easy to determine since the fact of a purchase or sale of a stock is easily verified by documentation and does not depend on oral testimony. Id. at 742.
by the language of Section 10(b)\textsuperscript{25} and that the standing requirement in no way affected the enforcement authority of the SEC under Section 10(b) and Rule 10b-5.\textsuperscript{26} The Court did note that the adoption of the standing rule would deprive otherwise deserving plaintiffs of a federal cause of action,\textsuperscript{27} but stated in a footnote that the same plaintiffs were free to pursue applicable remedies for nonpurchasers and nonsellers under state law.\textsuperscript{28}

More recently, the Court has addressed the required nexus between the purchase or sale of a security and the fraudulent act in its decision in \textit{Securities and Exchange Commission v. Zandford}.\textsuperscript{29} \textit{Zandford} involved a securities broker who was convicted of misappropriating the proceeds of stock sales from an investment account of his clients.\textsuperscript{30} The SEC filed a civil action against Zandford for violation of Section 10(b) after his criminal conviction.\textsuperscript{31} The Court addressed the issue of whether Zandford's alleged fraudulent conduct was sufficiently in connection with the purchase or sale of any security.\textsuperscript{32} The Court held that Zandford's actions satisfied the "in connection with" requirement of Section 10(b) since his fraudulent action and the purchase or sale of the security were interdependent.\textsuperscript{33} Therefore, the Court established

\begin{itemize}
  \item \textsuperscript{25} \textit{Id.} at 737 ("Having said all this, we would by no means be understood as suggesting that we are able to divine from the language of Section 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5 . . . . Such growth may be quite consistent with the Congressional enactment and with the role of the federal judiciary in interpreting it, but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5.").
  \item \textsuperscript{26} \textit{Id.} at 752 n.14 (noting that prior jurisprudence has established that the purchaser/seller standing requirement is no limitation on the standing of the SEC to bring actions for injunctive relief under Section 10(b) and Rule 10b-5).
  \item \textsuperscript{27} \textit{Id.} at 738.
  \item \textsuperscript{28} \textit{Id.} at 739 n.9.
  \item \textsuperscript{29} 535 U.S. 813 (2002).
  \item \textsuperscript{30} \textit{Id.} at 815–16.
  \item \textsuperscript{31} \textit{Id.} at 816.
  \item \textsuperscript{32} \textit{Id.} at 815.
  \item \textsuperscript{33} \textit{Id.} at 820 ("The securities sales and respondent's fraudulent practices were not independent events. This is not a case in which, after a lawful transaction had been consummated, a broker decided to steal the proceeds and did so. Nor is it a case in which a thief simply invested the proceeds of a routine...".)
\end{itemize}
that the nexus required between the fraudulent action and the purchase or sale of a security is one of interdependence and found that Section 10(b)'s broad scope, in terms of the phrase "in connection with," extended beyond misrepresentations regarding the value of a particular security.  

B. State Securities Laws and Common Law Causes of Action

Shareholders have employed multiple causes of action for securities fraud under state common law theories long before the passage of the 1934 Securities and Exchange Act. Included in these remedies is a theory of recovery for the loss a shareholder suffers when that shareholder is induced not to sell a security. Such common law theories generally fall under the category of either fraud or negligent misrepresentation. In addition to these general remedies, some states, including California, also recognize a cause of action for securities fraud under a theory of induced forbearance. Other states that recognize a similar cause of action include New York, Massachusetts, New Jersey, New Hampshire, and Wisconsin.

A common law cause of action for induced forbearance regarding the holding of a security is rooted in tort law. The Second Restatement of Torts provides that:

[O]ne who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary conversion in the stock market. Rather, respondent's fraud coincided with the sale themselves." (emphasis added).

34. Id. at 820.


37. Id. at 538.
loss caused to him by his justifiable reliance upon the misrepresentation.\textsuperscript{38}

The legal concept of forbearance establishes that if an individual has a right to do something, including the right to sell a share of stock, then the refusal to exercise that right has power and legal significance.\textsuperscript{39} The California court in *Greenfield* recognized the following as required elements for a common law claim of induced forbearance: (1) the corporate issuer of the shares must have made a representation; (2) the misrepresentation must have concerned a matter of fact, not opinion; (3) the misrepresentation must have been material to the shareholder's decision not to sell; (4) the misrepresentation must have been received by the shareholder; (5) the shareholder must have relied on the misrepresentation; (6) the shareholder's reliance must have been justified; and (7) the misrepresentation must have been the proximate cause of damage to the shareholder.\textsuperscript{40}

\section*{C. Congressional Shifts in the Balance}

Between the years of 1934 and 1995, Congress did little to alter the balance between these alternative regimes of securities fraud laws. However, Congress's passage of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), the National Securities Market Improvement Act of 1996 ("NSMIA"), and SLUSA in 1998 has profoundly altered the balance.

\subsection*{1. The PSLRA of 1995}

The PSLRA\textsuperscript{41} was passed by Congress to remedy perceived abuses by plaintiff classes of private Section 10(b) actions. It is comprised primarily of procedural reforms designed to make it

\begin{itemize}
  \item \textsuperscript{38} Restatement (Second) of Torts § 525 (1977).
  \item \textsuperscript{39} *Greenfield*, 98 Cal. Rptr. 2d at 539.
  \item \textsuperscript{40} *Id.* at 543. After listing the above seven factors, the California court retorted, "[I]n no way is this a slam-dunk windfall for plaintiffs." *Id.*
\end{itemize}
more difficult to bring federal private securities fraud actions.\textsuperscript{42} Included within these procedural reforms are heightened pleading requirements\textsuperscript{43} and an automatic stay of discovery upon the filing of a motion to dismiss.\textsuperscript{44} Although, after enacting the PSLRA, Congress was satisfied that it had put into place adequate procedural reforms to discourage abusive private use of Section 10(b), it soon became apparent that plaintiff classes could evade the statute's rigorous requirements by bringing an action for securities fraud in state courts.\textsuperscript{45} Congress was thereby convinced that it needed to take legislative steps to close the loophole inadvertently created by the PSLRA.

2. The NSMIA of 1996

A significant interim legislative step between the PSLRA and SLUSA was made by Congress through the passage of the NSMIA.\textsuperscript{46} Congress enacted the NSMIA to promote efficiency and capital formation in the financial markets.\textsuperscript{47} Specifically, the NSMIA preempted state registration of nationally traded securities.\textsuperscript{48} The NSMIA defined a covered security as a security that is:

(1) Listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed, or authorized for listing, on the National Market System of the NASDAQ Stock Market (or any successor to such entities);

(2) Listed, or authorized for listing, on a national securities exchange (or tier or segment thereof) that has listing


\textsuperscript{44} \textit{id.} § 77z-1(b).

\textsuperscript{45} O’Hare, \textit{supra} note 42, at 337.


\textsuperscript{47} \textit{id.}

standards that the Commission determines by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards applicable to securities described in subparagraph (A); or

(3) Is a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraph (A) or (B).  

The NSMIA marked a decisive Congressional step to set aside the duality between state and federal registration that had marked securities law since the enactment of the Securities Act of 1933. As such, the NSMIA represented an early indication of Congressional policy favoring uniform national regulation and standards imposed on nationally-traded securities, policy which would come to fruition in 1998. However, by its terms, the NSMIA did not affect state anti-fraud remedies or the viability of state defrauded holder claims.

3. SLUSA of 1998

Out of the background of the PSLRA and the NSMIA, SLUSA was enacted by Congress to stop the federal flight of securities fraud class actions into state court. In its statement of findings preceding the text of SLUSA, Congress acknowledged that the flight of federal securities fraud class actions had frustrated the purposes of the PSLRA. Furthermore, Congress claimed that it was appropriate to create uniform standards for nationally-traded securities “while preserving appropriate enforcement power of State securities regulators” in order to prevent state securities law

49. Id. § 77r(b)(1).


52. Id. § 2 (codified at 15 U.S.C.A. § 78a (2005)).
from being used to evade the stricter requirements of the PSLRA.\textsuperscript{53} The substance of SLUSA’s preemption provision states that:

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) an untrue statement 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.\textsuperscript{54}

SLUSA includes a companion removal provision that corresponds to the preemption provision. This portion of the statute states:

Any covered class action brought in any State court involving a covered security, as set forth in subsection (b), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to subsection (b).\textsuperscript{55}

Borrowing from the language of the NSMIA, the statute provides the definition of a covered security\textsuperscript{56} as well as a covered class action.\textsuperscript{57} However, SLUSA expressly excludes shareholder derivative actions from the Act’s preemptive scope.\textsuperscript{58} The statute also excludes a group of state class actions, the so-called “Delaware Carve-Outs.”\textsuperscript{59} The carve-outs were excluded to

\begin{itemize}
\item \textsuperscript{53} Id.
\item \textsuperscript{54} 15 U.S.C. § 77p(b) (2005).
\item \textsuperscript{55} Id. § 77p(c).
\item \textsuperscript{56} Id. § 77p(f)(3) (“The term ‘covered security’ means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 77r(b) of this title . . . .”). See id. §§ 77r(b)(1) and (2) (defining a covered security using criteria based on the security’s listing with the New York Stock Exchange, the American Stock Exchange, the Nasdaq or any successor to such entities).
\item \textsuperscript{57} Id. § 77p(f)(2).
\item \textsuperscript{58} Id. § 77p(f)(2)(B).
\item \textsuperscript{59} Id. § 77p(d)(1).
\end{itemize}
preserve state court class actions for breach of the fiduciary duty of disclosure, a duty imposed on corporate officers and directors by the law of the corporation's state of incorporation.\(^6^0\)

Courts have digested the multiple provisions within SLUSA into a four-part test used to determine whether the preemption provision applies to a specific action. The test provides that SLUSA's preemption provision applies when the following conditions have been satisfied: (1) the action is a covered class action; (2) the action purports to be based on state law; (3) the defendant has been alleged to have misrepresented or omitted a material fact, or to have used or employed any manipulative device or contrivance; and (4) the defendant has been alleged to have engaged in fraudulent conduct \emph{in connection with} the purchase or sale of a covered security.\(^6^1\)

\section*{III. The Scorned Broker: The Dabit Case and the Federal Circuit Split}

Despite a consensus among the federal courts of appeals on the required elements of SLUSA preemption, there was not complete agreement among the federal circuit courts regarding the applicability of SLUSA preemption to state securities fraud class action claims brought by defrauded holders of securities. Since such class action suits are characterized by a plaintiff class comprised of defrauded shareholders who have not sold their stock, these claims do not satisfy the \textit{Blue Chip Stamps} purchaser/seller standing rule by their own definition. This portion of the casenote addresses the position taken by the Second Circuit on the issue and the growing divergence among the federal courts of appeals. The Second Circuit joined a substantial majority of the courts of appeals who had ruled in favor of excluding state

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securities law holding claims from SLUSA's preemptive scope. Only one circuit ruled against the exclusion of state holding claims and found that SLUSA is a statute of complete preemption, a conclusion with considerable jurisdictional implications.

A. The Dabit Case

Former Merrill Lynch broker Shadi Dabit brought suit against his employer on behalf of himself and other current and former Merrill Lynch brokers in April of 2002 in the Western District of Oklahoma. The suit was filed after New York Attorney General Eliot Spitzer announced a pending investigation into conflicts of interest at large investment firms, including the defendant brokerage firm. Dabit alleged that, during the period of December 1, 1999, to December 31, 2000, the members of the putative class had purchased and refrained from selling Merrill Lynch-recommended securities upon the advice of Merrill Lynch's analysts. The complaint also alleged that the putative plaintiffs had lost clients as a result of the purchases of the recommended stocks and Merrill Lynch's alleged misconduct. Attached to the complaint was a list of stocks purchased by Dabit and recommended to his lost customers during the class period and a report prepared by the Office of the Attorney General of New York describing Merrill Lynch's scheme to promote its investment banking business by recommending certain stocks and causing their prices to inflate. Dabit sought relief for Merrill Lynch's alleged breach of fiduciary duty and the covenant of good faith and fair dealing, presumably under Oklahoma law.

The Western District of Oklahoma dismissed Dabit's first complaint in October of 2002 as preempted by SLUSA, but gave him the opportunity to re-plead since it acknowledged that Oklahoma law conceivably recognized such holding claims.

64. Id. at 29.
65. Id. Dabit filed the action in the Western District of Oklahoma alleging jurisdiction on diversity grounds.
66. Id.
Dabit amended his petition merely to replace references to purchases of securities with references to the holding of securities, defining the putative class to include "brokers who owned and continued to own one or more of the [Merrill Lynch] recommended securities . . . or recommended such securities to their clients during the period of December 1, 1999 through December 31, 2000." As before, the amended complaint requested damages for Merrill Lynch's breach of fiduciary duty and covenant of good faith and fair dealing and attached the list of Merrill Lynch-recommended securities and the report of the New York Attorney General as exhibits. However, before the Western District of Oklahoma could determine whether the amended complaint also was preempted by SLUSA, Dabit's complaint was combined with more than 120 other cases against Merrill Lynch in the Southern District of New York by the Judicial Panel for Multidistrict Litigation. Merrill Lynch quickly filed a motion to dismiss Dabit's complaint as preempted by SLUSA. The Southern District of New York ruled in April of 2003 that Dabit's complaint fell "squarely within SLUSA's ambit" and dismissed the complaint.

On appeal, the Second Circuit found that SLUSA did not preempt claims that do not allege purchases or sales made by the putative class members. In its opinion, the Second Circuit struggled with the issue of the appropriate interpretation of the phrase "in connection with the purchase or sale of a covered security." The court walked a tight line between the broad construction of the phrase within Section 10(b) established by Zandford and the narrow construction of the judicially-inferred private right of action established in Blue Chip Stamps. The court first announced its presumption that Congress intended the phrase to have the same meaning in SLUSA as it has in Section 10(b). After a careful analysis of the Blue Chip Stamps opinion, the court then reasoned that the limitation on standing to bring a private suit

67. Id.
68. Id. at 29–30.
70. Dabit, 395 F.3d at 28.
71. Id. at 35–36.
under Section 10(b) is "unquestionably a distinct concept" from the statutory and regulatory prohibition against fraud in connection with the purchase or sale of securities. However, the court refused to reach the conclusion of its logic when it found that, regardless of the recognition that the standing requirement is independent of the statutory text, Congress meant to incorporate the settled standing rule along with the "in connection with" phrase since only purchasers and sellers have a federal private damages remedy. The court found that Dabit's complaint was preempted by SLUSA because it contained implicit allegations of purchases made by the putative class members. The Second Circuit directed the lower courts to dismiss Dabit's complaint without prejudice, allowing him to bring a new action that excluded allegations of fraud in connection with the purchase or sale of a security. The court vacated the Southern District of New York's dismissal of Dabit's lost commission claims.

B. The Majority Rule

Echoing the reasoning of the Second Circuit, those federal circuits that have found in favor of excluding state securities holding claims from the preemptive scope of SLUSA have done so on the basis of two arguments. First, like the Second Circuit, these circuits have relied on the presumption that Congress, in using the words "in connection with" in both the 1934 Act and SLUSA, intended for the words to have the same meaning in both instances. Second, these circuits have found no Congressional intent to broaden the reach of federal securities regulation beyond closing the federal flight gap created after the passage of the PSLRA of 1995.

72. Id. at 39.
73. Id. at 40.
74. See Green v. Ameritrade, Inc., 279 F.3d 590 (8th Cir. 2002); Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334 (11th Cir. 2002). See also discussion infra Part III.B.1.
1. Presumption of Congressional Knowledge of Settled Judicial Interpretation

The most commonly relied-upon argument in favor of finding that SLUSA does not preempt state holding claims is that Congress used the words "in connection with" with knowledge of their settled judicial interpretation. This reasoning first appeared in the Western District of Texas case Gutierrez v. Deloitte & Touche, L.L.P. The Gutierrez court presumed that Congress was aware of the interpretation of Section 10(b) of the 1934 Act which incorporates the purchaser/seller rule adopted in Blue Chip Stamps. After making this presumption, the court reasoned that Congress could have elected to expand the scope of SLUSA beyond the limitation associated with the words "in connection with" by providing that claims alleging misrepresentation in connection with the failure to purchase or sell a security were also removable to federal court. The court then held that SLUSA's removal provision only applies to actions which allege misrepresentations or omissions in connection with the purchase or sale of a covered security.

The first federal circuit court to adopt similar reasoning was the Eighth Circuit in 2002. The court reasoned that, in enacting SLUSA, Congress was aware of the settled judicial interpretation of Section 10(b) of the 1934 Act. That judicial interpretation established that state law was left to fill in the gaps left by federal securities law, which did not recognize a cause of action for the nonpurchase or nonsale of a security. In the same year, the

76. 147 F. Supp. 2d 584 (W.D. Tex. 2001). Although the Western District of Texas is located within the federal Fifth Circuit, the Fifth Circuit has not affirmatively spoken regarding this issue. The Gutierrez case was remanded to the 224th Judicial District Court of Bexar County, Texas, for lack of federal subject matter jurisdiction. Id. at 595. Therefore, the Fifth Circuit did not have an opportunity to address the issue raised in the district court.
77. Id.
78. Id.
79. Id.
80. Green v. Ameritrade, Inc., 279 F.3d 590 (8th Cir. 2002). This reasoning has also been adopted by the Second Circuit. See Dabit, 395 F.3d 25.
81. Green, 279 F.3d at 598.
82. Id.
Eleventh Circuit also cited this presumption in recognizing that SLUSA does not preempt state holding claims, although the court also added that a claim is preempted by SLUSA when it sweeps within its ambit actual purchases or sales of stock. In other words, the Eleventh Circuit acknowledged that, although SLUSA does not preempt state law holding claims, a plaintiff may not merely plead around SLUSA's preemption provision.

2. No Congressional Intent to Go Beyond Closing the Federal Flight Loophole

Although there appears to be tension between Congress's stated purpose in the passage of SLUSA and the incorporation of the purchaser/seller standing rule through the words "in connection with," some courts have determined that there exists no contradiction between the two. The Second Circuit was the first court to speak to this reasoning. In Dabit, the court claimed that there was no legislative history to support the conclusion that Congress intended SLUSA to preempt claims that did not satisfy the purchaser/seller standing rule of Blue Chip Stamps. Rather, the court claimed that the statement of findings preceding the text of SLUSA suggests that Congress intended to preempt only those claims that had migrated from federal court into state court in order to avoid the heightened pleading standards put into place by the PSLRA. In other words, the court reasoned that Congress drafted SLUSA to be no broader than necessary to prevent private state securities class action suits from being used to frustrate the purposes of the PSLRA. The Third Circuit employed a similar rationale in 2005, explaining that Congress's use of the words "in connection with" in SLUSA provided for the uniform application of federal fraud standards without expanding or constricting the substantive reach of federal securities regulation.

84. Dabit, 395 F.3d at 41.
85. Id.
86. Id.
C. The Minority Rule

The Seventh Circuit is the only federal court of appeals to adopt the opposite position in finding that SLUSA’s preemption provision does extend to state securities fraud holding claims. The SEC has sided with this circuit’s contrary view. Arguments supporting the minority view assert that Congress intended to preempt such state causes of action in passing SLUSA, that the policy considerations supporting the purchaser/seller standing rule established in Blue Chip Stamps do not apply to the application of SLUSA, and, most significantly, that SLUSA is a statute of complete preemption, thus a legal duality between federal and state private securities fraud claims involving nationally-traded securities no longer exists.

1. Congressional Intent to Go Beyond Closing the Federal Flight Loophole

The Seventh Circuit, in an opinion written in 2005 by Judge Easterbrook, held that, because SLUSA is as broad as Section 10(b) itself, the limitations imposed on private rights of action under Section 10(b) do not open the door to litigation of securities transactions under state laws. The court reasoned that SLUSA is designed to prevent plaintiffs from migrating to state court to evade rules for federal securities litigation under the PSLRA. Because those rules included the Blue Chip Stamps standing requirement, the court explained that interpreting SLUSA not to preempt state securities fraud holding claims would be contrary to

90. See Kircher, 403 F.3d 478. See also discussion infra Parts III.C.1-3.
91. Kircher, 403 F.3d at 484. The Seventh Circuit is careful to distinguish between Section 10(b) enforcement actions and the use of Section 10(b) for private actions. The court claims that the purchaser/seller standing rule does not apply to SEC enforcement actions and it is in this sense that SLUSA is as broad as Section 10(b) itself. Id. at 483.
92. Id. at 482.
the stated purpose of SLUSA. The court noted the distinction between the use of Section 10(b) for SEC enforcement actions, in which a broad construction of the phrase “in connection with” is employed, and the use of Section 10(b) for private rights of action, in which the narrow purchaser/seller rule is applied to plaintiffs as established under Blue Chip Stamps. The court found that because the narrow purchaser/seller standing rule is not required by the language of Section 10(b), the broad interpretation of the phrase “in connection with the purchase or sale” of a security should be applied to the construction of SLUSA’s preemption provision. The court reasoned that it would be ironic that a Supreme Court decision intended to limit private litigation by non-traders would become the springboard from which that very litigation could be pursued under state law, despite Congress’s contrary view that all securities fraud class actions should proceed under federal law.

Advocates of the minority rule also argue that it is not deleterious to their position that there is no mention in the Congressional record of a Congressional intent to preempt state securities holding claims. Congressional reports from the committees that participated in the drafting of SLUSA can be read to find intent to preempt devices not considered specifically at that time, but which would also have the effect of undermining the PSLRA. A report issued by the Senate Committee on Banking, Housing, and Urban Affairs states that, although the committee felt it had successfully reached all actions that could be used to circumvent the PSLRA, SLUSA should be interpreted broadly to reach actions and other procedural devices that could be used to get around the class action definition. Proponents of the minority view cite this statement as evidence of a Congressional intent that

94. Kircher, 403 F.3d at 483.
95. Id.
97. Kircher, 403 F.3d at 484.
98. Ratner, supra note 35, at 1049.
99. Id.
SLUSA be construed in a way to ensure that the protections of the PSLRA were enforced in practice.  

2. Policy Considerations Supporting Preemption

In an amicus brief to the Second Circuit, the SEC cited policy considerations as one of the reasons to find that SLUSA's preemption provision should extend to state law holding claims. The SEC argued that the purchaser/seller standing rule was designed as a limitation to judicially-inferred private rights of action under Section 10(b) in order to eliminate vexatious lawsuits characterized by difficult issues of proof. However, the SEC argued that if the same limitation were applied to SLUSA, it would produce the opposite effect from that intended by Congress, allowing suits with precisely the same undesirable characteristics to go forward. Essentially, the SEC argued to the Second Circuit that the words "in connection with" as used in SLUSA should not be interpreted in the same way as they have been regarding a private right of action because the relevant policy considerations supporting the purchaser/seller rule are not present in SLUSA. Conversely, the SEC argued that the broad interpretation of "in connection with" established in Zandford should be applied to the construction of the phrase in SLUSA. The Second Circuit did not accept this argument.

Nevertheless, the Seventh Circuit cited other policy concerns in its opinion in Kircher. The court argued that since private causes of action under Section 10(b) are judicially created, the courts are the ultimate arbiters of defining the scope of the purchaser/seller standing rule incorporated through the words "in connection with." Section 10(b), as originally intended, creates a federal regulatory standard, permitting the SEC to enforce the prohibition

100. Id.
102. Id.
103. Id. at 21.
through administrative proceedings. The Supreme Court in *Blue Chip Stamps* chose to limit the judicially-inferred private right of action under Section 10(b) in an effort to confine such actions to situations where litigation is apt to do more good than harm. Therefore, the Court reasoned that federal courts retain the authority to interpret the words “in connection with” in the context of a private right of action under Section 10(b), and should do so in a manner that will be socially productive without having that interpretation apply in other contexts.

3. Complete Preemption of State Securities Fraud Class Actions

The most compelling argument in support of the minority rule is that SLUSA is a statute of complete preemption, meaning that Congress succeeded in transforming every class action securities fraud claim involving a nationally-traded security into a federal claim. Such a conclusion reached by a court carries significant weight as it alters the general rules of pleading. The complete preemption doctrine is an exception to the well-pleaded complaint rule, which prohibits a court from reading into the plaintiff’s complaint in order to discern the true nature of the plaintiff’s claim. The well-pleaded complaint rule makes the plaintiff the master of his complaint—he or she may plead around a federal statute so as to avoid invoking federal question jurisdiction. Furthermore, a defendant may not remove to federal court asserting federal question jurisdiction on the basis that a federal question is likely to be raised in the defense. Accordingly, a plaintiff may avoid removal by omitting federal claims.

However, general pleading rules do not apply if a completely preemptive federal statute is invoked. Under the complete preemption doctrine, the preemptive force of a federal statute may

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106. *Id.*
107. *Id.*
108. O’Hare, * supra* note 42, at 344. *See also* Behlen v. Merrill Lynch, 311 F.3d 1087, 1090 (11th Cir. 2002).
111. *Id.*
be so extraordinary that a state common law complaint is converted into a federal claim. Under this rationale, a state common law claim falling within the scope of a statute of complete preemption is necessarily federal in character, and a defendant may remove the claim to federal court under the general removal statute, 28 U.S.C. § 1441.

The SEC strongly advocated this argument to the Second Circuit as amicus curiae, claiming that SLUSA intentionally altered the federal-state relationship by preempting all state securities fraud claims. The SEC encouraged the Second Circuit to recognize that the effect of SLUSA was to make any claim within SLUSA’s preemptive scope completely federal in nature. The ultimate outcome of such a finding would be dismissal of the complaint if the action had been brought only under a state law theory of fraudulent inducement. This argument ultimately won the day in the Second Circuit, although the court declined to take it as far as the SEC would have liked. The Second Circuit acknowledged that “Congress could not have spoken more clearly” regarding its intent to completely preempt the field of certain types of state securities class action suits. The court’s limitation of certain types of class action suits referred to other substantive limitations within SLUSA, including the purchaser/seller standing rule incorporated through the words “in connection with.” The court then reasoned that this finding leads to the conclusion that Congress’s complete preemption of these certain types of securities fraud claims provides an exception to the well-pleaded complaint rule such that “the plaintiff has necessarily invoked federal question jurisdiction, even though he [or she] did not wish to [sic].”

112. O’Hare, supra note 42, at 345.
113. Id. at 346.
115. Id. at 8. The action would be removed to federal court under SLUSA’s removal provision, where it would be dismissed under SLUSA’s preemption provision for failure to state a claim.
117. Id.
The Seventh Circuit followed similar reasoning when it held that the plaintiffs' common law holding claims in *Kircher* were actually disguised Section 10(b) claims that should have been brought in federal court.\(^{118}\) Although the Seventh Circuit did not specifically find that SLUSA was a statute of complete preemption, the court, in practice, applied the complete preemption exception to the well-pleaded complaint rule by reading between the lines of the plaintiffs' petition to find grounds for dismissal.\(^{119}\) The court reasoned that the plaintiffs' claims depended on statements made or omitted in connection with their own purchase of securities.\(^{120}\) Therefore, the plaintiffs' effort to define a non-purchaser and non-seller class was designed to evade the PSLRA in order to litigate a securities class action suit in state court with the intent of winning an idiosyncratic award from a local judge or jury.\(^{121}\) The court further commented that the plaintiff class's perceived evasion of PSLRA standards was the very sort of maneuver that SLUSA was designed to prevent.\(^{122}\) This argument has been accepted by the Third Circuit\(^ {123}\) and tacitly by the Eighth Circuit.\(^ {124}\)

**IV. THE DEATH OF THE STATE SECURITIES FRAUD CLASS ACTION LAWSUIT**

The Supreme Court of the United States heard oral arguments in Dabit's case on January 18, 2006, and returned its unanimous decision on March 21, 2006.\(^ {125}\) The Court adopted the Seventh Circuit's broad interpretation of SLUSA's preemptive scope by

\(^{118}\) *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005), vacated on other grounds, 126 S. Ct. 2145 (2006).

\(^{119}\) *Id.* The court stated that the plaintiffs could have brought their claims in federal court directly under Section 10(b) and Rule 10b-5. *Id.*

\(^{120}\) *Id.*

\(^{121}\) *Id.*

\(^{122}\) *Id.*


\(^{124}\) *Dudek v. Prudential Securities*, 295 F.3d 590 (8th Cir. 2002). *See also Prof'l Mgmt. Assocs., Inc. Employees' Profit Sharing Plan v. KPMG*, 335 F.3d 800 (8th Cir. 2003).

finding that claims brought by holders of securities alleging the fraudulent manipulation of stock prices are preempted along with claims brought by purchasers and sellers of securities. However, in doing so, the Court left the questions regarding whether SLUSA represents Congress’s complete preemption of securities fraud class action suits and the SEC’s enforcement authority in preempted cases unanswered.

A. The Dabit Opinion

In agreeing with the Seventh Circuit’s construction of SLUSA’s preemption provision, the Court found that Congress had intended the phrase “in connection with the purchase or sale” of a security to incorporate the broad construction of the phrase developed under Zandford, not the purchaser/seller standing limitation created in Blue Chip Stamps. The Court also looked to policy considerations, including the PSLRA’s ultimate goal of eliminating vexatious suits, which supported its construction of SLUSA’s preemption provision.

1. Presumption of Congressional Knowledge of Settled Judicial Interpretation

The Court began by clearly stating that the Blue Chip Stamps purchaser/seller standing limitation is not required from the text of Section 10(b) or Rule 10b-5. It stated that the Blue Chip Stamps Court relied chiefly on policy considerations, rather than the text of the statute, in advocating the limitation. Furthermore, the Court reasoned that the Blue Chip Stamps decision addressed exclusively the scope of the private right of action, not the construction of the words “in connection with the purchase or sale” found in Rule 10b-5.

The Court also relied on the presumption of Congressional knowledge of settled judicial interpretation. It stated that this

126. Id. at 1507.
127. Id. at 1512. This is unlike the purchaser/seller standing limitation established in the Birnbaum decision, which relied on the language of Rule 10b-5. Id.
128. Id.
presumption is particularly required in the case of SLUSA’s preemptive provision since Congress used the exact same language found in Section 10(b) and Rule 10b-5 in a provision that appears in the same statute as Section 10(b).\textsuperscript{129} However, the Court departed from the Second Circuit’s reasoning by finding that Congress intended to incorporate the broad construction of the phrase established in \textit{Zandford} and \textit{O’Hagan} rather than the purchaser/seller standing limitation established in \textit{Blue Chip Stamps}. The Court reasoned that when it has construed the scope of Section 10(b) in its jurisprudence, it has sought to give it a broad interpretation.\textsuperscript{130} This broad interpretation under its precedent established that it is enough for the plaintiff to allege that the fraud “coincided” with any securities transaction, made by either the plaintiff or another party.\textsuperscript{131} The Court held that the language of Section 10(b), and therefore the language of SLUSA, required only fraud “in connection with the purchase or sale of any security,” not fraud perpetrated on an identifiable purchaser or seller.\textsuperscript{132}

2. Policy Considerations

The greatest policy concern cited by the Court was the intention of Congress in passing SLUSA. The Court reasoned that a narrow reading of the statute could not be reconciled with SLUSA’s stated purpose and would frustrate the effectiveness of the 1995 PSLRA.\textsuperscript{133} Furthermore, the Court stated that the question of whether or not a complaint alleges fraud “in connection with the purchase or sale” of securities was not to be determined by the identity of the plaintiffs.\textsuperscript{134} This portion of the Court’s opinion echoed similar concerns posed by the SEC’s amicus brief to the Second Circuit.\textsuperscript{135} Additionally, the Court looked to similar

\begin{itemize}
\item \textsuperscript{129} \textit{Id.} at 1513.
\item \textsuperscript{130} \textit{Id.}
\item \textsuperscript{132} \textit{Id.}
\item \textsuperscript{133} \textit{Id.}
\item \textsuperscript{134} \textit{Id.} at 1515.
\item \textsuperscript{135} See Brief for the SEC, \textit{supra} note 88, at 20.
\end{itemize}
policy concerns it had recognized in *Blue Chip Stamps*. The Court warned that the construction of SLUSA proposed by Dabit would give rise to wasteful, duplicative litigation since those facts supporting an action by purchasers under Rule 10b-5 in federal court generally also support an action brought by holders in state court. The Court expressed concern regarding the potential of parallel class actions proceeding in state and federal court with different standards governing their respective outcomes.

The Court also recognized a strong federal interest in protecting the efficient operation of the market for nationally-traded securities. After examining this strong federal interest, the Court could not identify a competing state interest. It recognized that the effect of SLUSA is only to deny plaintiffs the right to bring a class action suit to vindicate certain claims. Individual plaintiffs and groups of fewer than fifty plaintiffs retain the right to enforce any existing state-law cause of action under SLUSA. Furthermore, the Court stated that the parties could only identify one pre-SLUSA case involving a state securities fraud holding class action suit, although such suits were theoretically permissible both before and after *Blue Chip Stamps*. Hence, the Court concluded that Congress had not eliminated a historically entrenched state-law remedy in passing SLUSA.

**B. SLUSA and Complete Preemption**

The Court did not address the question of whether SLUSA should be interpreted to be a statute of complete preemption, an issue to which the Seventh Circuit responded affirmatively. Nevertheless, SLUSA should be interpreted to be a statute of

137. *Id.*
138. *Id.* at 1509.
139. *Id.* at 1514.
140. *Id.* (citing Weinberger v. Kendrick, 698 F.2d 61 (2d Cir. 1982)).
141. *Id.*
142. *See Kircher v. Putnam Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005), *vacated on other grounds*, 126 S. Ct. 2145 (2006) (applying the complete preemption exception to the well-pleaded complaint rule in practice by reading between the lines of the plaintiff’s petition to find grounds for dismissal).
complete preemption since the language of the statute suggests that Congress intended for federal law to provide the exclusive remedy for securities fraud class actions involving nationally-traded securities. Furthermore, Congress's inclusion of a specific removal right is not dispositive of a finding that SLUSA is a statute of complete preemption. The proper inquiry to be applied in determining whether a statute is intended to completely preempt state causes of action is whether Congress intended for the statute to provide the exclusive cause of action for the injury.\textsuperscript{143} If the circumstances surrounding the statute support such a finding, then the complete preemption doctrine applies and the action may be removed to federal court under Section 1441.\textsuperscript{144} Therefore, the doctrine of complete preemption requires that Congress both completely preempt an area of the law such that any civil complaint within the law's scope is necessarily federal in character and intend for the federal statute to provide the exclusive cause of action.

The statement of findings that precedes SLUSA in conjunction with specific exclusions for state causes of action within SLUSA suggests that Congress intended to establish federal securities law as the exclusive remedy for securities fraud class action suits involving nationally-traded securities. Congress found that it was necessary to establish national standards for securities class action lawsuits involving nationally-traded securities.\textsuperscript{145} Also, SLUSA expressly excludes shareholder derivative suits,\textsuperscript{146} as well as a class of claims for the breach of state-imposed fiduciary duties referred to as the "Delaware Carve-Outs."\textsuperscript{147} In view of the legal maxim \textit{expressio unius est exclusio alterius},\textsuperscript{148} it may be inferred that Congress did intend to provide the exclusive remedy for securities fraud class action suits involving nationally-traded

\textsuperscript{143}. O'Hare, \textit{supra} note 42, at 346–47 (citing Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 9 n.5 (2003)).


\textsuperscript{147}. \textit{Id.} § 77p(d)(1). \textit{See also} Berne & Friel, \textit{supra} note 60.

\textsuperscript{148}. The expression of one thing is the exclusion of another. BLACK'S LAW DICTIONARY 1717 (8th ed. 2004).
securities and that Congress, therefore, did preempt all non-excluded state securities fraud class action suits, including defrauded holder claims.

Those opposing complete preemption argue that Congress’s inclusion of a specific removal provision within SLUSA suggests that it did not intend for SLUSA to completely preempt all state securities fraud class action suits. In effect, the doctrine of complete preemption is a removal doctrine, because once a statute is recognized to be completely preemptive, a claim under state law automatically becomes a federal claim removable to federal court under the general removal statute. Consequently, the complete preemption doctrine is unnecessary to remove an action under the general removal statute if a statute exists containing a specialized removal provision. The problem with this reasoning, however, is that Congress’s decision to include a removal provision within SLUSA is not dispositive of a finding that SLUSA is a statute of complete preemption. Viewed from another perspective, Congress’s choice to include a removal provision within SLUSA is indicative of its intent to ensure a specific removal right for class action suits falling within SLUSA’s preemptive scope.

C. Collateral Impact on the SEC

In addition to the question regarding complete preemption, the issue of SLUSA’s collateral impact on the SEC’s enforcement authority also remains unanswered. There is no doubt that SLUSA does not directly impact the SEC’s enforcement authority since it was drafted to affect only private class action suits brought for securities fraud. However, how is the SEC’s enforcement authority impacted after a court determines that a certain class action complaint is not preempted by SLUSA? The United States Supreme Court has made it clear that SLUSA incorporates the broad construction of the phrase “in connection with the purchase or sale” of a security—the construction that applies to the SEC’s enforcement of Section 10(b) violations. Therefore, in order for a court to determine whether SLUSA preempts a particular claim,

150. O’Hare, supra note 42, at 371.
that court must necessarily determine whether the SEC has enforcement authority in the matter. Because all non-exempted claims falling within the language of SLUSA would be preempted, a conclusion that a private claim was not preempted would be tantamount to a conclusion that the conduct involved fell outside of the SEC's authority to enforce Section 10(b).

This reasoning was presented to the Court during oral argument of the Dabit case by Dabit's counsel. Justice Stevens, the author of the Dabit opinion, responded to the argument with the conclusion that the SEC would not be bound by a district court's decision in a private suit and would be free to re-litigate the matter. However, the Court's opinion belies such an easy conclusion since it reasons that facts supporting an action by holders typically also will support an action by purchasers under Section 10(b) and Rule 10b-5. Therefore, even though the SEC may not be bound by a district court's determination of whether the complaint satisfies the "in connection with the purchase or sale" requirement, the district court's determination still stands as persuasive authority against the SEC's enforcement power.

V. CONCLUSION

Congress was deliberate in altering the duality between federal and state regulation of nationally-traded securities when it enacted SLUSA. In the Merrill Lynch v. Dabit opinion, the Supreme Court settled a dispute among the federal appellate circuits and affirmed Congress's position by holding that SLUSA preempts state securities fraud holding claims in addition to claims brought by purchasers and sellers. This interpretation eliminates the risk of wasteful, competing litigation in state and federal courts. Additionally, such a construction of SLUSA comports with the encompassing policy goal of all federal securities regulation—to promote an efficient and honest market for all nationally-traded securities. However, the Court's opinion does not answer questions regarding complete preemption and the collateral impact

of the Court's interpretation on the SEC's enforcement authority. Therefore, even though the state securities fraud class action suit may be dead, questions surrounding the interpretation and application of SLUSA will continue to be litigated in federal courts.

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