

Supreme Court thwarts securities “holder” class actions

On March 21, 2006, the U.S. Supreme Court, in *Merrill Lynch v. Dabit*, issued an important ruling that thwarted an attempt by investors to circumvent federal statutory limits on securities fraud class actions. The Court rejected an attempt by a class of plaintiffs to sue under state law for losses they claimed to have suffered because the defendants’ misrepresentations induced them to hold onto securities. The Court’s ruling significantly cut back on the ability of plaintiffs to file securities class actions in state court.

In its unanimous opinion, the Court once again expressed its concern that frivolous securities cases pose a unique threat to individual businesses and the economy as a whole, and re-affirmed the role of the courts in fulfilling Congress’ intent to rein in abuses. The Court plainly signaled that it was in no mood to expand shareholder remedies where Congress had plainly attempted to limit them.

Background: federal securities litigation reform in the 1990s

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA), overriding a presidential veto. The legislative history of the PSLRA shows that Congress was greatly concerned that frivolous securities lawsuits were causing significant damage to investors, the securities markets and the national economy. The legislation contained important protections for companies and their officers and directors, including the now-familiar “safe harbor” for forward-looking statements. It also erected new procedural hurdles for class actions under the federal securities laws, including

stricter requirements for pleading fraud and an automatic stay of all pre-trial discovery until after a court had determined that the complaint might have merit.

Soon after the enactment of the PSLRA, plaintiffs’ lawyers began attempting to evade the statute by filing securities fraud cases in state courts, invoking state securities laws or general state anti-fraud statutes. It soon became apparent that these lawyers were attempting an end-run around the procedural obstacles Congress had imposed. As far as companies and their officers and directors were concerned, this was potentially even worse for them than the pre-PSLRA situation, because now they could face exposure under the differing laws and judicial interpretations of 50 state courts.

In response, Congress enacted the Securities Litigation Uniform Standards Act (SLUSA) in 1998. SLUSA reflected Congress’s determination that litigation involving nationally traded securities should not be subject to differing state laws and standards. Under SLUSA, a class action alleging a misrepresentation or omission “in connection with the purchase or sale of” a security could only be maintained under federal law—namely, the Securities Act of 1933 and the Securities Exchange Act of 1934. While SLUSA contained exceptions for derivative suits and certain other limited categories of cases, it clearly suggested that state law would no longer be applied to securities fraud claims.

The “holder” class action and the claim in *Dabit*

SLUSA clearly pre-empted state law claims for fraud in connection with *purchases*

or *sales* of stock. Not ready to concede defeat, plaintiffs’ lawyers developed a new strategy to circumvent SLUSA. They began to file class actions in state court on behalf of “holders” of a security—investors who claimed that they had been wrongly induced by a defendant to *continue to hold* previously purchased stock, thereby suffering damages when its price declined. Since they had neither bought nor sold on the basis of a misrepresentation or omission, the argument went, their claims were not pre-empted by SLUSA. A number of state courts, including a divided California Supreme Court, accepted this effort by plaintiffs to bring securities cases under state law.

The plaintiffs in *Dabit* were stock brokers for Merrill Lynch, who claimed that the

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brokerage firm damaged them by fraudulently manipulating stock prices. As a result, the plaintiffs claimed, they lost money when they continued to hold overvalued stock, and when their clients, upon learning the “truth” about these securities, took their business elsewhere. The U.S. Court of Appeals for the Second Circuit held that the “holder” claims were not precluded by SLUSA; in a separate case, the Seventh Circuit reached the opposite conclusion.

The Supreme Court unambiguously held that “holder” class actions were pre-empted by SLUSA. Because federal law does not recognize “holder” claims for securities fraud, *Dabit* effectively puts an end to the “holder” class action.

The Supreme Court’s reasoning

The Court’s opinion is as interesting for what it says about securities litigation in general as for the result reached in the immediate case. It suggests that the Court continues to be concerned about frivolous shareholder lawsuits, and that the judiciary should continue to be vigilant where plaintiffs seek to expand the boundaries of the law beyond Congressional intent and existing precedent.

The plaintiffs in *Dabit* pursued a clever line of argument. In the 1975 *Blue Chip Stamps* case, the Supreme Court had interpreted the “purchase or sale” language in the Exchange Act quite narrowly, in order to limit the categories of persons who could sue for fraud under the federal securities laws to those who claimed that they had actually bought or sold stock because of the fraud. Therefore, the plaintiffs argued, when Congress used the same “purchase or sale” language in SLUSA, it was similarly limiting the categories of plaintiffs whose state-law claims were being pre-empted by federal law. As a result, Congress never intended to bar state-law “holder” claims, and their claim should be allowed to proceed.

The justices acknowledged the surface appeal of this argument, but rejected it. The Court concluded that in light of prior

legislative and judicial history, Congress’s clear intent in 1998 had been to create “national standards for securities class action lawsuits involving nationally traded securities.” The Court observed that in the *Blue Chip Stamps* case, it had found that “holder” class actions “pose a special risk of vexatious litigation,” and concluded that it would be “odd, to say the least, if SLUSA exempted that particularly troublesome subset of class actions from its pre-emptive sweep.”

The Court also observed that if it permitted state-law holder class actions, it would be encouraging litigation abuse and inefficiency. The Court envisioned a scenario in which a single alleged misrepresentation could give rise to both a purchaser class action in federal court and a parallel holder class action in state court. This, the justices concluded, would be “wasteful, duplicative litigation.”

Finally, the Court harked back to earlier decisions expressing its view that securities fraud litigation “presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general. Even weak cases,” the Court observed, “may have substantial settlement value, because the very pendency of the lawsuit may frustrate or delay normal business activity.” In light of negative publicity surrounding Enron, WorldCom and other companies, this language was a needed reminder of the dangers of abusive litigation.

Conclusion

The *Dabit* case will not stop the filing of frivolous securities class actions, but it will help keep them in federal court, where significant statutory protections exist. This is a welcome result for all defendants, because it signals the Supreme Court’s continuing concern about the potential for abuse in the securities class action arena, and its willingness to step in where necessary to prevent these abuses. ■