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## State Securities Class Action Suits: Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit

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### Summary

The United States Supreme Court has granted certiorari in the Second Circuit case *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*. The Second Circuit held that in certain instances the federal Securities Litigation Uniform Standards Act of 1998 does not preempt securities state class action suits. Four months after the Second Circuit decision, the Seventh Circuit took a very different approach to the issue. The Supreme Court decision should resolve this split in the circuits. This report will be updated as needed.

On September 25, 2005, the United States Supreme Court granted the petition for writ of certiorari to the United States Court of Appeals for the Second Circuit in the case *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*.<sup>1</sup> The issue to be decided is when can a company face a securities state class action suit based on claims that the company misled investors.

Two separate appeals brought by former and current Merrill Lynch brokers (Dabit) and by a Merrill Lynch retail brokerage customer (IJG Investments), alleging that Merrill Lynch issued biased research and investment recommendations about companies in order to obtain investment banking business, were consolidated by the Second Circuit. The earlier cases had been dismissed as preempted by the Securities Litigation Uniform Standards Act of 1998 (SLUSA).<sup>2</sup>

SLUSA was enacted in response to the perceived failure of the Private Securities Litigation Reform Act of 1995 (PSLRA)<sup>3</sup> to curb alleged abuses of securities fraud litigation. PSLRA set out a framework for the bringing of securities fraud cases in federal courts. In many instances, plaintiffs circumvented PSLRA by bringing cases in state

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<sup>1</sup> No. 04-1371, *Dabit v. Merrill Lynch, Pierce, Fenner & Smith*, 395 F.3d 25 (2d Cir. 2005).

<sup>2</sup> P.L. 105-353, 112 Stat. 3227.

<sup>3</sup> P.L. 104-67, 109 Stat. 737.

courts on the basis of common law fraud or other non-federal claims. SLUSA attempted to make certain that plaintiffs could not avoid the PSLRA requirements by requiring securities fraud cases to be brought only in federal court and only under a uniform standard if five criteria are satisfied: 1. The lawsuit is a covered class action; 2. The claim is based on state statutory or common law; 3. The claim concerns a covered security; 4. The plaintiff alleges a misrepresentation or omission of a material fact; and 5. The misrepresentation or omission is made in connection with the purchase or sale of a covered security.

The Second Circuit court examined the language of section 10(b) of the Securities Exchange Act,<sup>4</sup> which is the general antifraud provision of the act, and Rule 10b-5,<sup>5</sup> the rule issued by the Securities and Exchange Commission (SEC) to implement the statutory provision. In its examination, the court found that the “in connection with” requirement of SLUSA should be interpreted in the same way that courts have interpreted the phrase in the antifraud provision and in the Rule. In its analysis of past cases which have interpreted this statute and Rule, the Second Circuit stated that the fraud at issue must be “integral to the purchase and sale of the securities in question.”<sup>6</sup> Further, in *Blue Chip Stamps v. Manor Drug Stores*<sup>7</sup> the Supreme Court ratified the doctrine that a private litigant may bring an antifraud action only if an actual purchaser or seller of the securities in question.

The Second Circuit found it necessary to look at judicial interpretations of the “in connection with” requirement and the standing issue of a private litigant in order to determine whether standing under SLUSA would be comparable and whether SLUSA could be found to preempt all claims that might be brought under state law. The court found that in enacting SLUSA Congress sought only to ensure that class actions brought by plaintiffs satisfying the actual purchaser-seller requirement are subject to the federal securities laws.

SLUSA, as we have repeatedly noted, was intended to bolster the PSLRA, which in turn was intended to toughen the requirements for maintenance of a successful action under Rule 10b-5. We need not and do not reach the question, but see no contradiction in concluding that Congress could have intended to preempt state law securities fraud actions that if brought under federal law would fail for proof of loss causation or lack of timely filing, but did not intend to preempt a category of actions that, because of the nature of the injury alleged, could never have constituted a potential federal action.<sup>8</sup>

The remainder of the court’s opinion concerned the damages claims by the parties. Dabit asserted claims for two types of damages: 1. holding damages concerning Merrill Lynch’s dissemination of fraudulent information which induced him and the class which he represented to retain certain securities and 2. commissions that Dabit would have

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<sup>4</sup> 15 U.S.C. § 78j(b).

<sup>5</sup> 17 C.F.R. § 240.10b-5.

<sup>6</sup> *Dabit*, at 37.

<sup>7</sup> 421 U.S. 723 (1975).

<sup>8</sup> *Dabit*, at 43.

earned from clients which he lost because of Merrill Lynch's dissemination of allegedly fraudulent information. As for the claim for holding damages, the court stated that, because this kind of claim did not satisfy the *Blue Chip* standing requirement necessary for the "in connection with" requirement of the antifraud provision and its Rule, SLUSA did not generally preempt these holding claims. However, when Dabit asserted that he and the class which he represented both purchased and retained stocks based upon Merrill Lynch's misrepresentation, he satisfied the *Blue Chip* standing requirement and ran afoul of SLUSA, which was intended to preempt claims alleging fraud in connection with the purchase or sale of securities. The court ordered that these claims be dismissed without prejudice so that the plaintiff might plead a claim sounding in state law if possible. His claim concerning lost commissions, brought on behalf of himself and other brokers, fared better than the holdings claim, with the court stating that this kind of claim by its nature did not allege fraud coinciding with the purchase or sale of a security. The court therefore allowed this claim as not preempted by SLUSA.

IIG Investments attempted to recover damages caused by paying commissions or fees to Merrill Lynch by entities having brokerage accounts with Merrill Lynch. The court held that claims for flat annual fees were not preempted by SLUSA but that claims for commissions were preempted because commissions by definition involve allegations of a purchase or sale of securities "in connection with" the alleged conduct.

In April 2005, four months after *Dabit*, the Seventh Circuit rejected the Second Circuit approach. The Seventh Circuit held in *Kircher v. Putnam Funds Trust*<sup>9</sup> 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."<sup>10</sup> "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, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all."<sup>11</sup>

The Supreme Court decision should resolve this split in the circuits as to when certain securities state class action claims are not preempted by SLUSA.

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<sup>9</sup> 403 F.3d 478 (7<sup>th</sup> Cir. 2005).

<sup>10</sup> *Kircher*, at 484.

<sup>11</sup> *Id.* at 484.