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In March 2006, for the second time in twelve months, the U.S. Supreme Court considered a case concerning securities class action lawsuits. In the first, *Dura*, the Court addressed — and then rejected — the "price inflation" method for calculating damages. The case was discussed in the May 2005 issue of CUG.COMments (http://www.cug.com/img/pdf/ ISSUE38.pdf). The second case, *Dabit*, concerns the appropriate forum for securities class action lawsuits and is discussed in this issue.

The Dabit Decision: A Loophole Closed

Background

The Public Securities Litigation Reform Act of 1995 (PSLRA) had produced the unintended consequence of securities class action plaintiffs avoiding federal court and pursuing their action in the state system. As a result, the Securities Litigation Uniform Standards Act of 1998 (SLUSA) was enacted to push securities class action lawsuits out of state courts and back into the federal court system where the pleading standards created by PSLRA are more stringent and uniform.

The critical language in SLUSA bars covered class actions from proceeding under state law if they arose out of the "purchase or sale" of securities.

But what if a private party wanted to bring a class action alleging damages not because the party had purchased or sold securities, but had simply held on to them? Would such "holding" shareholders fall outside the "purchase or sale" criteria of SLUSA, and thus be permitted to proceed in state court? For such holder cases state law was the only recourse left: in the *Blue Chip Stamps* case of 1975 the Supreme Court had effectively all but precluded holder class action cases from being maintained under federal securities law.

Shadi Dabit

Shadi Dabit was a stockbroker with Merrill Lynch. He contended that "deceptive devices" used by his employer caused certain stocks to trade at "artificially inflated" prices and led Dabit to hold on to certain stocks he would otherwise have sold had he known their true value. Dabit's grievance therefore came not from being a purchaser or a seller, but a holder. After *Blue Chip Stamps* the federal route was denied to him: could he avoid the requirements of SLUSA and pursue a class action in state court?

The Second Circuit Court

The Second Circuit Court of Appeals sided with Dabit. Adopting a literal interpretation of the SLUSA language, the court held that SLUSA applied strictly to claims by purchasers and sellers. "We see no clear indication either in the text or the legislative history of SLUSA of a congressional intent to abolish nonpurchaser and nonseller class action claims." Dabit — whose original suit had also included purchasers but was amended to a class of those "who owned and continued to own" — could therefore pursue his case in state court. This conclusion was consistent with rulings from the Eighth and Eleventh Circuits.

The Seventh Circuit Court

A couple of months after the Second Circuit ruling, the Seventh Circuit was faced with a similar case involving holders of mutual funds (*Kirchner v. Putnam Funds*). The Seventh Circuit decision was different from that of the Second. A unanimous panel ruled that "plaintiffs' claims are connected to their own purchase of securities and thus are blocked [from state court] by SLUSA." In other words, every holder was once a purchaser.

The U.S. Supreme Court

In light of these conflicting positions the Supreme Court agreed to hear the *Dabit* case and resolve the question. On March 21, 2006, Justice Stevens delivered the unanimous opinion of the Court that supported the Seventh Circuit's interpretation.

In doing so, Justice Stevens pointed out that the "magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated." He noted that the PSLRA of 1995 had had the unintended effect of prompting some plaintiffs' attorneys to "avoid the federal forum altogether," rather than deal with the difficulties caused by that Act. It was to stop this shift from federal to state courts that the follow-on SLUSA was enacted.

Justice Stevens acknowledged that at first sight a narrow interpretation of the phrase "in connection with the purchase or sale" would not be unreasonable; but he went on to say that a narrow "literal reading" would undercut the effectiveness of the 1995 Reform Act. Allowing for certain securities class action lawsuits to be pursued in state courts would raise the prospect of "parallel class actions proceeding in state and federal court with different standards governing claims asserted on identical facts."

Summary

As had been widely expected, the loophole sought by Shadi Dabit to sidestep the requirements of SLUSA and file a securities class action on behalf of holders of securities in state court was therefore closed. For the purposes of SLUSA there is no distinction between holders of securities and purchasers or sellers. The Supreme Court pointed out that it is only the use of the class action device to vindicate certain claims that is affected. Those that still have recourse under state law include: individual plaintiffs, groups consisting of less than 50 plaintiffs, and derivative suits brought on behalf of the corporation. ❖

The complete Supreme Court opinion can be seen at:
http://www.supremecourtus.gov/opinions/05pdf/04-1371.pdf

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