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ATTORNEYS AT LAW

SECURITIES LITIGATION UPDATE

ELEVENTH CIRCUIT ISSUES DECISION RIGOROUSLY APPLYING PREEMPTION PROVISIONS OF THE SECURITIES LITIGATION UNIFORM STANDARDS ACT

On October 29, 2008, the United States Court of Appeals for the Eleventh Circuit issued an opinion in Instituto De Prevision Militar v. Merrill Lynch ("IPM"), holding that the Securities Litigation Uniform Standards Act ("SLUSA") precluded an individual plaintiff's non-class action state law claims. For defendants confronted with state law claims involving allegations of securities fraud, the decision is noteworthy for its treatment of the plaintiff's individual lawsuit as part of a "covered class action" barred by SLUSA; its rigorous application of SLUSA's expansive language; and its insistence that non-preempted claims, if they exist, be clearly and separately pleaded in the plaintiff's complaint.

Enacted in 1998, SLUSA was intended to combat a shift by securities class action plaintiffs from federal law and federal court – where claims are governed by the strict requirements of the Private Securities Litigation Reform Act of 1995 – to state law and state court. The statute accomplishes this objective by providing for the removal to federal court and the subsequent dismissal of (i) any "covered class action," (ii) under state law, (iii) alleging a misrepresentation or omission of material fact, (iv) in connection with the purchase or sale, (v) of a "covered security." The principal question in IPM was whether the plaintiff's non-class action suit was nonetheless a "covered class action" precluded by SLUSA because it had, with the plaintiff's consent, been consolidated for discovery purposes with a federal class action.

The plaintiff, an agency charged with administering social security for Guatemala's armed forces, sued Merrill Lynch in state court under state law alleging that Merrill Lynch facilitated a fraud by Pension Fund of America, L.C. ("PFA"), a pension fund company that sold "retirement trust accounts" that contained mutual funds. At the time the plaintiff filed its state suit, three related actions were pending in federal court: a civil action by the SEC against PFA (the "SEC Action"); a class action brought by PFA investors against PFA's principals, Merrill Lynch, and other defendants (the "Class Action"); and a separate individual action the plaintiff brought against Lehman Brothers (the "Lehman Action"). In response to a federal court order that suits by PFA investors be filed as ancillary proceedings in the SEC Action, the plaintiff dismissed its state case against Merrill Lynch and filed an ancillary proceeding in federal court alleging state law theories.

Merrill Lynch moved to dismiss, arguing that SLUSA barred the plaintiff's state law claims. While the motion to dismiss was pending, the plaintiff moved to consolidate the Class Action and the Lehman Action for discovery purposes. In response to an order from the district court, the plaintiff agreed that its suit against Merrill Lynch should be consolidated with the Class Action and the Lehman Action for discovery purposes as well. The district court agreed and consolidated all three cases.

Thereafter, the district court granted Merrill Lynch's motion to dismiss. The plaintiff responded with a second amended complaint alleging the same state law claims and an additional federal claim under Section 10(b) of the Securities Exchange Act. Merrill Lynch again moved to dismiss, arguing that the state law claims were precluded by SLUSA and that the plaintiff failed to state a Section 10(b) claim. The district court again granted the motion, and the plaintiff appealed.

Affirming the district court's dismissal, the Eleventh Circuit made two important rulings significant to defendants faced with the prospect of defending state law claims based on securities fraud.

First, the court held that the plaintiff's individual action against Merrill Lynch nonetheless qualified as a "covered class action" under SLUSA. As pertinent to the plaintiff's suit, SLUSA defines a "covered class action" to include (i) any "group of lawsuits," (ii) filed or pending in the same court, (iii) involving common questions of law or fact, (iv) seeking damages on behalf of more than 50 persons, and (v) that are joined, consolidated, or otherwise proceed as a single action "for any purpose." The court held that these elements were met because:

- the plaintiff's case, the Class Action, and the Lehman Action were all pending in the same court;
- the plaintiff's claim, the Class Action, and the Lehman Action involved "common questions" about the way PFA represented itself to investors and whether those representations were "in connection with the purchase or sale of a security";

- the Class Action sought damages for roughly 3,400 class members, so that the suits collectively sought damages on behalf of more than 50 persons; and
- the cases had been consolidated "for any purpose" because the plain meaning of that statutory phrase unambiguously includes cases that have been consolidated for discovery purposes.

The court rejected the plaintiff's argument that its individual case against Merrill Lynch should not be barred by SLUSA because Congress "intended to preserve bona fide individual actions like this case." Although it recognized that the structure and legislative history of SLUSA supported this claim, the court held that "a hunt through legislative history" was unnecessary in light of SLUSA's unambiguous "for any purpose" language, which clearly embraced actions consolidated for discovery purposes. The court noted that the plaintiff might have avoided this problem had it argued in the district court that consolidation was inappropriate because it might result in SLUSA preemption and clarified that, in light of the plaintiff's consent to consolidation in the district court, it was not deciding "whether a consolidation over the plaintiff's objection that results in preclusion under SLUSA may amount to an abuse of discretion."

Second, the court held that, to avoid a complete dismissal of a complaint under SLUSA, a plaintiff must clearly and expressly plead a cause of action that does not involve fraud in connection with the purchase or sale of a covered security. The complaint in IPM leveled multiple factual allegations against Merrill Lynch, and the plaintiff argued that the allegations supporting some of its claims were not allegations of fraud "in connection with the purchase or sale" of a "covered security,"[1] but rather garden-variety theories of embezzlement and theft that are not preempted. Recognizing that there might be some truth to this, the court nonetheless concluded that the "main building blocks" of the complaint focused on precluded claims of fraud in connection with the purchase of securities, thus requiring dismissal. Leaving open the question whether SLUSA requires a claim-by-claim analysis of each count in a complaint, the court held that:

> the Act does not require district courts to act like a prospector panning for a few non-precluded theories amid a river of precluded ones. Rather, to avoid preclusion under SLUSA, a claim for relief should clearly state the ground on which it is based, and that ground cannot be one that is "in connection with the purchase or sale" of a security under § 10(b) and SLUSA. If a single claim premises liability on multiple factual theories, then that claim would be precluded if at least one of those theories hinges on representations made "in connection with the purchase or sale" of a security.

The specific deficiencies with the complaint in IPM may be avoided with precise pleadings and careful pretrial practice. Nonetheless, the opinion provides defendants with strong arguments for the dismissal of state law claims where securities fraud forms the "main building blocks" of a complaint, both in class actions and in individual cases involving significantly related civil actions where consolidation or similar procedural devices are likely to be used.

[1] The court concluded that the plaintiff's complaint alleged fraud "in connection with" a purchase or sale of a "covered security" because (i) the plaintiff "was complaining about fraud that induced it to invest with PFA, which means that its claims are 'in connection with the purchase or sale' of a security" and (ii) that PFA's retirement trust accounts were "covered securities" because they contained a mutual fund component, which satisfied the definition of "covered security" in the statute and under Eleventh Circuit precedent.

If you have any questions, please feel free to contact Samuel J. Salario, Jr. or Christopher M. Sacco.

Samuel J. Salario, Jr.
813.229.4337
ssalario@carltonfields.com

Christopher M. Sacco
813.229.4237
csacco@carltonfields.com