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Seventh Circuit Holds That SLUSA Preempts Market-Timing Class Actions

When Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), it was meant to prevent end-runs around the rules intended to screen out frivolous securities lawsuits. The U.S. Court of Appeals for the Seventh Circuit's recent opinion reads SLUSA carefully and broadly in an opinion that required ten putative class actions to be dismissed that had brought state law claims for alleged damages from market-timing in mutual funds and variable annuities.

On April 5, 2005, in a consolidated case entitled *Kircher v. Putnam Funds Trust*, 2005 U.S. App. LEXIS 5372, the Seventh Circuit reversed 10 judgments issued by three separate judges of the U.S. District Court for the Southern District of Illinois on the ground that the complaints were precluded by SLUSA, which was enacted by Congress in order to prevent plaintiffs from engaging in end-runs around the rules governing securities class actions by bringing equivalent suits under state law in state courts.

The ten lawsuits before the Seventh Circuit had been brought against mutual funds, fund advisors, and an insurance company as putative class actions. Plaintiffs had alleged that each was liable for damages, on various state law grounds, for failing to prevent traders in mutual funds and funds associated with variable annuities from taking advantage of the time differentials between U.S. and foreign markets to gain arbitrage profits and allegedly harm the funds' other investors.

The putative class actions had initially been filed in the increasingly notorious Madison County, Illinois state trial court. The defendants had removed the actions to federal court and asked the district court judges to dismiss the complaints under SLUSA. The district courts had remanded the actions to state court, and the

defendants appealed. The Seventh Circuit initially determined that it had jurisdiction to hear the appeals. See *Kircher v. Putnam Funds Trust*, 373 F.3d 847 (7th Cir. 2004). In its most recent decision, the Seventh Circuit decided the merits of these appeals and ordered the district courts to undo the remand orders they had issued and dismiss the plaintiffs' claims.

The issue before the Seventh Circuit was whether the cases must be dismissed under SLUSA's broad preemption of securities-like complaints brought in the guise of state law claims. SLUSA defines the types of cases Congress intended to preclude by defining their characteristics. Only one of these characteristics was at issue in the consolidated *Kircher* case—whether the alleged misconduct was "in connection with" the purchase or sale of securities.

The complaints in nine of the ten actions were virtually identical. They defined the putative classes as all people holding shares in at least one of the named mutual funds during a five-year period. The Seventh Circuit noted that these plaintiffs had attempted to avoid SLUSA by defining the putative classes of plaintiffs as "holders" of funds rather than purchasers or sellers, but held that "this class definition is a flop." The court concluded that the substantial daily turnover in each of the funds, and the failure of plaintiffs to exclude those who purchased or sold shares during the period, meant that the class necessarily included many people who purchased or sold shares during the five-year period.

Therefore, it concluded that, whatever the full scope of SLUSA, the claims alleged misconduct in connection with plaintiffs' purchase or sale of

securities and were therefore preempted. This part of its decision was entirely consistent with decisions of the Second, Third, and Eleventh Circuits, as well as numerous district courts. See *Rowinski v. Salomon Smith Barney*, 398 F.3d 294 (3d Cir. 2005); *Dabit v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005); *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334 (11th Cir. 2002).

The Seventh Circuit viewed the tenth complaint, *Spurgeon v. Pacific Life Insurance Company*, as presenting the harder question: whether a class action that expressly excludes everyone who purchased or sold securities during the relevant time period can be preempted by SLUSA. In other words, can plaintiffs avoid SLUSA preemption by bringing class actions solely on behalf of “holders” of securities? In light of the many and various attempts by plaintiffs’ attorneys in the past few years to do exactly that, the Seventh Circuit’s fresh and careful look at the question has implications well beyond the market-timing cases before that court.

The Seventh Circuit began its analysis by noting that the “in connection with” language in SLUSA is taken from, and virtually identical to, language in Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, and that every court of appeals that has addressed the meaning of the “in connection with” language in SLUSA has held that it has the same scope as in Section 10(b) and Rule 10b-5. The court noted that Section 10(b) both prohibits certain conduct and permits the SEC to enforce that prohibition, and that the SEC is not required to show that the agency or the United States purchased or sold securities in order to do so. Therefore, the court concluded, the “in connection with” language simply ensures that the misconduct involves securities transactions rather than some other activity.

The Seventh Circuit recognized that the well-known Supreme Court decision, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), had set forth what has become known as the purchaser-seller rule, which limits the availability of private suits under Section 10(b) or Rule 10b-5 to those who purchased or sold securities. But the court explained that the Supreme Court’s purchaser-seller rule was a judicially-fashioned limit on the judicially-created private right of action under Section 10(b). *Blue Chip Stamps*, it concluded, had not interpreted the statute or regulation as including this limitation, and it noted that a number of Supreme Court decisions since *Blue Chip Stamps* had reiterated this point.

Thus, the Seventh Circuit determined that by depicting the putative class of plaintiffs as containing only non-traders, the *Spurgeon* complaint had succeeded only in defining securities claims that could be enforced solely by the SEC and not by private plaintiffs. The court then considered

whether the SEC could maintain an action under Section 10(b) or Rule 10b-5 against securities companies that fraudulently or manipulatively increased investors’ exposure to arbitrage—the gist of the plaintiff’s allegations.

The court decided that there were circumstances in which the SEC could do so—citing, as an example, a fund that issues a prospectus stating that certain actions would be taken to prevent arbitrageurs from exploiting the fact that the fund’s net asset value is calculated only once a day, but that does not in fact take such actions. Therefore, because SLUSA’s coverage is as broad as Section 10(b)’s, the court concluded that the plaintiff’s claims were precluded by SLUSA.

The Seventh Circuit also expressed its view that the plaintiff’s actual complaint—notwithstanding his pleading—was really a complaint that the investment was more susceptible to arbitrage by market-timers than the prospectus had led him to believe, a claim based on statements allegedly made or omitted in connection with his own purchase of the securities that could have been brought directly under Rule 10b-5.

The court viewed the plaintiff’s effort to define a non-purchaser/non-seller class as a deliberate evasion of the federal requirements for bringing a securities action in order to litigate in state court in the hope that a local judge or jury might produce an idiosyncratic award, and concluded that this was exactly the type of maneuver SLUSA was designed to prevent. The court emphasized that SLUSA’s scope was not limited to investors with winning federal claims. Rather, SLUSA “covers both good and bad securities claims—especially bad ones.” *Kircher*, at *15.

Several Courts of Appeals have addressed this question before, although in only one was the court’s decision based on it. The Ninth Circuit, in *Falkowski v. Imation Corp.*, 309 F.3d 1123 (2002), assumed that SLUSA preempts only those actions brought by purchasers or sellers, but found that SLUSA preempted the claims before it by deciding that employees holding stock options were purchasers.

The Eleventh Circuit, in *Riley*, expressly stated that *Blue Chip Stamps*’ purchaser-seller rule was an interpretation of the “in connection with” language of Section 10(b), and therefore that SLUSA, by adopting that language, did not preempt actions brought by nonpurchasers/nonsellers, but like *Falkowski* found that SLUSA preempted the claims before it because the class included purchasers. The Eighth Circuit applied the same assumption to reject SLUSA preemption of the claims before it. See *Green v. Ameritrade, Inc.*, 279 F.3d 590 (2002).

Only the Second Circuit had previously attempted to analyze the question. In *Dabit*, decided three months before *Kircher*, the Second Circuit also decided that SLUSA preempted the claims before it, but included an extended discussion of whether SLUSA can preempt actions by nonpurchasers/nonsellers. The court stated that SLUSA's "in connection with" requirement is the same as Section 10(b)'s, and acknowledged that the circuit had previously explained that the *Blue Chip Stamps* purchaser-seller rule was entirely distinct from Section 10(b)'s prohibition on fraud in connection with the purchase or sale of securities.

Nonetheless, the court concluded that it was far more natural to suppose that, in enacting SLUSA, Congress meant to import the purchaser-seller rule along with the "in connection with" phrase as a substantive standard, relying on the absence of the legislative history's specific mention of holding claims in reaching its conclusion.

The Seventh Circuit is therefore the first Court of Appeals to conclude that the *Blue Chip Stamps* purchaser-seller rule does not narrow the reach of SLUSA preemption. Instead, SLUSA blocks state law class actions complaining about misstatements, or manipulative or deceitful conduct in connection with securities transactions, whether or not the plaintiffs themselves were purchasers or sellers.

Dechert LLP represented Pacific Life Insurance Company in this case.

This Legal Update was authored by Paul Huey-Burns (+1.202.261.3433; paul.huey-burns@dechert.com), Steven B. Feirson (+1.215.994.2489; steven.feirson@dechert.com), Kathleen N. Massey (+1.212.698.3686; kathleen.massey@dechert.com), and Nory Miller (+1.215.994.2369; nory.miller@dechert.com)

Practice group contacts

For further information on this decision contact one of the attorneys listed or any Dechert LLP attorney with whom you are in regular contact. Visit us at www.dechert.com/financialservices or www.dechert.com/financialserviceslit

Paul Huey-Burns
Washington
+1.202.261.3433
paul.huey-burns@dechert.com

William K. Dodds
New York
+1.212.698.3557
william.dodds@dechert.com

Stephen J. McConnell
Philadelphia
+1.215.994.2281
stephen.mcconnell@dechert.com

Frances S. Cohen
Boston
+1.617.728.7173
frances.cohen@dechert.com

Steven B. Feirson
Philadelphia
+1.215.994.2498
steven.feirson@dechert.com

Nory Miller
Philadelphia
+1.215.994.2369
nory.miller@dechert.com

Douglas P. Dick
Newport Beach
+1.949.442.6060
douglas.dick@dechert.com

Kathleen N. Massey
New York
+1.212.698.3686
kathleen.massey@dechert.com

Jeffrey S. Poretz
Washington
+1.202.261.3358
jeffrey.poretz@dechert.com



U.S.
Boston
Charlotte
Harrisburg
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Newport Beach

Palo Alto
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U.K./Europe
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