

CLIENT ALERT

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Supreme Court Clarifies When State Law Claims Are Removable Under the Securities Exchange Act of 1934

SPEED READ

Because of the procedural reforms enacted by the Private Securities Litigation Reform Act of 1995 and the heightened pleading standards adopted by the Supreme Court in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*, securities plaintiffs often prefer to litigate in state court. The Supreme Court recently held in *Merrill Lynch v. Manning* that, despite the exclusive federal jurisdiction provision of the Securities Exchange Act of 1934, plaintiffs can bring state law claims in state courts complaining about conduct that violates the federal securities laws. Only when a plaintiff's claim turns on the resolution of a substantial and disputed issue of law under the Exchange Act or its regulations will the federal courts be the exclusive jurisdiction for resolution of state law claims.

On May 16, 2016, the U.S. Supreme Court issued its decision in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 578 U.S. ____ (May 16, 2016), which resolved a longstanding circuit split as to the scope of exclusive federal jurisdiction under Section 27 of the Securities Exchange Act of 1934 (Exchange Act). That statute provides for exclusive federal jurisdiction of all cases "brought to enforce any liability or duty created by the [the Exchange Act] or the rules or regulations thereunder." *Manning* holds that the scope of Section 27's exclusive federal jurisdiction must be assessed using the same test used to decide whether a case "arises under" a generic federal law for purposes of 28 U.S.C. § 1331. As a result, state courts retain jurisdiction over state-law-based securities suits that only incidentally involve Exchange Act requirements, even if the complaint specifically asserts breach of an Exchange Act duty. Such suits are no longer removable.

The Debate in *Manning*

In *Manning*, the plaintiffs (seven investors in the stock of Escala Group, Inc.) brought an action in New Jersey state court against Merrill Lynch, UBS Securities, Citadel Derivatives Group, and other defendants, alleging that they were harmed by the defendants' practice of facilitating "naked short sales" of Escala stock. The claims were asserted not under federal law, but instead under various New Jersey statutory and common law theories. Despite alleging only state-law claims, the complaint referenced the U.S. Securities and Exchange Commission's Regulation SHO, which prohibits short sellers from intentionally failing to deliver securities, and suggested that Merrill Lynch had violated both Regulation SHO and New Jersey state law. Manning's complaint was removed to federal court on the theory that it actually stated claims under the Exchange Act for violation of Regulation SHO, over which federal courts have exclusive jurisdiction. Manning moved unsuccessfully for remand, but the Third Circuit reversed, and the Supreme Court ultimately upheld the Third Circuit's decision.

In the Supreme Court, the parties advanced competing tests for whether there is exclusive federal jurisdiction under Section 27. Manning argued that federal jurisdiction should exist only where the Exchange Act or its regulations create the causes of action that a plaintiff asserts; Merrill Lynch, in contrast, argued for an expansive view of exclusive federal jurisdiction that would encompass a claim whenever the complaint, explicitly or implicitly, asserts that the defendants breached an Exchange Act duty, even if the complaint pleads only state-law theories, and even if the plaintiff may prevail on those claims without proving any breach of an Exchange Act duty.

The Court's Decision

In its decision, authored by Justice Kagan, the Court did not adopt either side's approach, but charted a middle path: a claim falls within federal courts' exclusive jurisdiction under the Exchange Act either when it is brought directly under the Exchange Act or its regulations, or when it "necessarily raise[s] [an issue under the Exchange Act or its regulations that is] actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance of federal and state power." The Court further noted that this rubric "typically fits cases ... in which a state-law cause of action is 'brought to enforce' a duty created by the Exchange Act because the claim's very success depends on giving effect to a federal requirement." In so deciding, the Court took pains to note that the grant of exclusive federal jurisdiction over Exchange Act claims does not diminish state courts' important role as the primary adjudicators of state-law claims, even if those claims implicate incidentally some federal question under a statute vesting federal courts with exclusive jurisdiction over claims brought under it. The Court expressed confidence in federal courts' ability to apply the familiar "arising under" test to jurisdictional questions under Section 27, and in state courts to follow federal courts' interpretations of the Exchange Act when called upon to apply that statute.

Writing for himself and Justice Sotomayor, Justice Thomas concurred in the judgment, advocating for a somewhat broader test for exclusive jurisdiction: one that would shunt to federal court *all* cases necessarily raising for the court's determination whether there has been a breach of an Exchange Act duty, regardless whether it is substantial or actually disputed.

The *Manning* ruling decided only the question of federal jurisdiction, and the Court expressed no view on the merits of the underlying claims. The effect of the ruling is to allow the case to proceed in state court, to be decided in the ordinary course by the New Jersey state courts.

Implications of *Manning*

Although not as restrictive as it could have been, *Manning* has the effect of limiting the scope of exclusive federal jurisdiction under the Exchange Act, and thus expands the ability of state courts to adjudicate cases incidentally raising Exchange Act issues. In the process, the Court also has expanded the ability of plaintiffs to avoid having their cases removed to federal court by artfully pleading alleged Exchange Act violations as state-law claims, although the extent to which they will be able to do this in practice remains to be seen. Language in the Court's opinion suggests that, to the extent that a state-law claim nonetheless necessarily raises a genuinely disputed issue under the Exchange Act, exclusive federal jurisdiction may attach.

In many cases, moreover, plaintiffs' efforts to litigate large securities cases in state court will remain limited. The Securities Litigation Uniform Standards Act of 1998 (SLUSA) already prevents plaintiffs from bringing most large class actions based on deception or manipulation "in connection with the purchase or sale of" most nationally traded securities. Such suits may be removed to federal court and precluded even though only state law claims are asserted, and even if no analogous claim exists under federal law. The impact of the Court's holding in *Manning* is thus likely to be more significant in individual suits and suits involving non-nationally traded securities, which lie outside of SLUSA's preclusive ambit, than in large class actions already covered by SLUSA. Many securities class actions will also be removable under the Class Action Fairness Act. On balance, therefore, *Manning* provides only a modest benefit to securities plaintiffs, and does not portend a wholesale shift of securities litigation to state courts.

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