

CLIENT ALERT

Supreme Court Allows Securities-Related Claims to Proceed in State Court

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The United States Supreme Court has unanimously upheld a ruling allowing securities-related claims in state court notwithstanding that the Securities Exchange Act of 1934, as amended (the Act) generally grants exclusive jurisdiction to federal courts for securities litigation. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Manning*, No. 14-1132, 578 U.S. __ (2016), decided on May 16, 2016, the Supreme Court allowed short-selling manipulation claims to proceed in a New Jersey state court under New Jersey causes of action. Justice Elena Kagan, writing for the majority, reasoned that the Act's jurisdictional provision restricts federal court exclusivity for securities claims under the same standards applicable to federal questions in general. The ruling is significant because it provides greater opportunities for plaintiffs to assert securities-related claims in state court under state law legal theories and causes of action.

I. The Manning Litigation

The plaintiff allegedly held two million shares of a NASDAQ-listed stock that purportedly plummeted. Plaintiff attributed the significant stock drop to "naked short selling" allegedly engaged in by various financial institutions. Naked short selling differs from ordinary short selling in that the seller never obtains nor delivers to the buyer the promised shares. Pursuant to the Act's Regulation SHO, short sellers are prohibited from intentionally failing to deliver securities to buyers. Plaintiff claimed that the financial institutions participated in short selling because defendants supposedly could neither possess nor obtain sufficient stock to deliver to the buyers. Foregoing federal securities claims, the plaintiff brought the case in New Jersey state court, asserting claims only under New Jersey common law and statutes. The complaint, however, expressly referenced Regulation SHO and suggested that the financial institutions had violated the Act's short-selling restrictions.

The financial institutions removed the case to federal district court as a case involving claims for which the federal courts have original jurisdiction. The federal district court denied plaintiff's attempt to remand to state court on two grounds. First, pursuant to the general federal question jurisdiction statute, 28 U.S.C. § 1331, the case was deemed a "civil action[] arising under" federal law. Second, based on the Act's Section 27 specific jurisdictional provision, the federal court was adjudged to have exclusive jurisdiction over the case insofar as it was "brought to enforce any liability or duty created by [the Act] or the rules and regulations thereunder. 15 U.S.C. § 78aa(a).

The Court of Appeals for the Third Circuit, however, reversed and remanded the case to state court. It reasoned that all of the causes of action were asserted under state law and none "necessarily raised a federal issue." Based on Supreme Court interpretation of similar jurisdictional provisions, the Third Circuit held that Section 27 of the Act only covers those cases meeting Section 1331's "arising under" test applicable to federal question statutes in general. And because the district court lacked Section 1331 jurisdiction over the state law claims alleged in the action, it also could not be considered an exclusive forum pursuant to Section 27 of the Act. The financial institutions sought Supreme Court review specifically as to the question of whether Section 27 of the Act mandated that the case be brought in federal court.

II. The Supreme Court's Decision

The Supreme Court unanimously decided to uphold the Third Circuit’s decision in a majority opinion written by Justice Kagan and a concurring opinion authored by Justice Thomas. Based on the text of Section 27, Supreme Court precedents interpreting identical specific jurisdictional statutes and the need to show deference to state courts as well as pursue clear and administrable rules, the majority held that Section 27 “confer[s] exclusive federal jurisdiction of the same suits as ‘arise under’ the Exchange Act pursuant to the general federal question statute.”

Textually, the majority interpreted Section 27’s language conferring exclusive jurisdiction to actions “brought to enforce any liability or duty created by [the Act] or the rules or regulations thereunder” to mean “§ 27 confers federal jurisdiction when an action is commenced in order to give effect to an Exchange Act requirement.” That is, the Act does not “embrace any complaint that happens to mention a duty established by the Exchange Act.” Conversely, Section 27 is not limited to claims asserted under the Act. Rather, exclusive jurisdiction under Section 27 certainly applies to “an Exchange Act cause of action” but also to “a suit raising a state-law claim [that] rises or falls on the plaintiff’s ability to prove the violation of a federal duty.” In other words, where “a state-law action necessarily depends on a showing that the defendants breached the Exchange Act, then the suits could also fall within § 27’s compass.”

The majority explained its interpretation of Section 27’s “brought to enforce a duty” language is synonymous with the “arising under” federal law scope of Section 1331’s general federal question jurisdictional provision. In general, the majority amplified, “[m]ost directly, and most often, federal jurisdiction attaches when federal law creates the cause of action asserted . . . [b]ut even when ‘a claim finds its origins’ in state law, there is a ‘special and small category of cases in which arising under jurisdiction still lies.’” The Supreme Court, therefore, held “that §27’s jurisdictional test matches the one we have formulated for § 1331,” meaning that a securities-related claim is only mandated to be in federal court where it “meets the ‘arising under’ standard.”

Beyond the textual analysis, the majority supported its holding in other ways. First, it relied on Supreme Court interpretation of similar jurisdictional statutes employing the “brought to enforce” language in which the Court “viewed the phrase as coextensive with our construction of [the] ‘arising under’” standard. Second, it instructed that its interpretation “serve[d] the goals we have consistently underscored in interpreting jurisdictional statutes.” Specifically, the Court advised that its “reading . . . gives due deference to the important role of state courts in our federal system,” especially the need “to keep state-law actions like [plaintiff]’s in state court.” Finally, the majority added that “[r]eading §27 in line with our §1331 caselaw also promotes ‘administrative simplicity[, which] is a major virtue in a jurisdictional statute.”

Justice Thomas, joined by Justice Sotomayor, wrote a concurring opinion agreeing that the suit belongs in state court but for different reasons. According to Justice Thomas, the case should be decided based on the “brought to enforce” language of Section 27 of the Act itself and not by reading into Section 27 the Section 1331 “arising under” standard applicable to all federal question claims. Section 27, Justice Thomas, contended, “establishes a straightforward test: If a complaint alleges a claim that necessarily depends on a breach of a requirement created by the Act, § 27 confers exclusive jurisdiction over that suit.” In this case, Justice Thomas determined, the complaint did not allege breaches of the Act’s requirements and so the case needed to be returned to state court.

III. Conclusion and Significance

Since the adoption of the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Securities Litigation Uniform Standards Act of 1998 (SLUSA), the Supreme Court has generally sided with efforts to restrict the scope and breadth of securities litigation. *Manning* could reflect somewhat of a departure from that approach. Based on the majority opinion, plaintiffs may

increasingly try to craft securities-related cases through state law causes of action to be asserted in state court. As long as the claims do not “depend[] on giving effect to a federal [securities law] requirement,” the case will not be subject to exclusive federal jurisdiction and can remain in state court.

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