

DISMISSING HOW THE PURCHASER-SELLER RULE AFFECTS SLUSA

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INTRODUCTION

In April, 2005, the Seventh Circuit decided the case of *Kircher v. Putnam Funds Trust and Putnam Investment Management, L.L.C.*¹ The result of this case limits the viability of state court securities actions by expanding the standing requirements for federal securities actions and by declaring that certain actions will either be preempted, compelled to be brought as derivative actions, or committed to public prosecutors.²

In *Kircher*, the plaintiff class, defining itself as entirely non-sellers and non-purchasers, brought suit in state court alleging securities fraud.³ The issue on appeal was whether their state law claims were preempted by the Securities Litigation Uniform Standards Act (“SLUSA”).⁴ The Seventh Circuit held that the purchaser-seller rule announced in the Supreme Court case *Blue Chip Stamps v. Manor Drug Stores*⁵ did not affect SLUSA’s coverage, and therefore a plaintiff class that only held securities, as opposed to one that

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¹ 403 F.3d 478 (7th Cir. 2005).

² *Id.*

³ *Id.* at 480, 482.

⁴ 15 U.S.C. § 77p (2000).

⁵ 421 U.S. 723 (1975).

purchased or sold securities, would nevertheless have their claims preempted by SLUSA.⁶ In addition, the Seventh Circuit held, in contradiction to its sister circuits, that the recourse for a non-trading class was to file a derivative action or commit the case to public prosecutors as opposed to relegating the case to state court.⁷

Part I of this note outlines the relevant federal securities laws at issue, including the Private Securities Litigation Reform Act of 1995 (“PSLRA”),⁸ § 10(b) of the Securities Exchange Act of 1934,⁹ and Rule 10b-5.¹⁰ Part II describes in detail the recent Seventh Circuit opinion in *Kircher*. Part III contrasts the *Kircher* decision with the 1975 Supreme Court case of *Blue Chip Stamps*, wherein the court held that plaintiffs who did not purchase or sell securities during the class period did not have standing to pursue a private damages action under Rule 10b-5. Part IV of this note compares the *Kircher* decision with how other circuits have interpreted the scope of SLUSA. Part V concludes that the Seventh Circuit was incorrect in concluding that SLUSA is not affected by the purchaser-seller rule in *Blue Chip Stamps* and that the proper recourse for a plaintiff class consisting of non-purchasers and non-sellers is to commit the case to public prosecutors or pursue a derivative action as opposed to litigating the claim in state court.

I. SLUSA

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 (“PSLRA”)¹¹ to “curb abuses of federal securities fraud litigation” arising under the Securities Act of 1933 and the

⁶ *Kircher*, 403 F.3d at 483-84.

⁷ *Id.* at 484.

⁸ Pub. L. No. 104-67, 109 Stat. 737 (codified in part at 15 U.S.C. §§ 77z-1, 78u-4 (2000)).

⁹ 15 U.S.C. § 78j(b) (2000).

¹⁰ 17 C.F.R. 240.10b-5 (2005).

¹¹ Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in part at 15 U.S.C. §§ 77z-1, 78u-4).

Securities and Exchange Act of 1934.¹² Pursuant to Rule 10b-5, which is based on § 10(b) of the 1934¹³ Act:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security*.¹⁴

Heightened pleading standards for class action plaintiffs were one of the reforms that the PSLRA imposed.¹⁵ However, a loophole was created, allowing plaintiffs to avoid the PSLRA's pleading

¹² *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 31 (2d Cir. 2005) (citing 15 U.S.C. § 77a et seq. (2000); 15 U.S.C. § 78a et seq. (2000)). For example, the PSLRA sought to deter strike suits in which private plaintiffs filed federal securities fraud claims of questionable merit in order to obtain large settlements. *See Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000).

¹³ 15 U.S.C. § 78j(b).

¹⁴ 17 C.F.R. § 240.10b-5 (emphasis added).

¹⁵ *Dabit*, 395 F.3d at 32 (citing 15 U.S.C. § 78u-4(b)). For example, a complaint under the PSLRA must allege that the defendant made an “untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” In addition, “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” 15 U.S.C. § 78u-4(b).

requirements by filing suits in state courts under state statutory or common law.¹⁶ As a result, the PSLRA failed to achieve its goal of curtailing meritless class actions, and in response Congress enacted the Securities Litigation Uniform Standards Act (“SLUSA”) in 1998.¹⁷ Congress enacted SLUSA in order to “prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives” of the PSLRA.¹⁸ Too many securities class action lawsuits had shifted from federal to state courts, thereby making it difficult to hold securities class action plaintiffs to the stringent standards of the PSLRA.¹⁹ Under SLUSA, Congress intended to close the loophole “by making federal court the exclusive venue for class actions alleging fraud in the sale of certain covered securities and by mandating that such class actions be governed exclusively by federal law.”²⁰ SLUSA provides parallel provisions to the Securities Act of 1933 and the Securities Exchange Act of 1934 in order to limit certain class actions under state law.²¹ The relevant portion reads:

No covered class action²² based upon the statutory
or common law of any State or subdivision thereof may

¹⁶ *Dabit*, 395 F.3d at 32.

¹⁷ 15 U.S.C. § 77p (2000).

¹⁸ Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, § 2, 112 Stat. 3227 (1998).

¹⁹ *Id.*

²⁰ *Dabit*, 395 F.3d at 33 (quoting *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 108 (2d. Cir. 2001)).

²¹ *Kircher v. Putnam Funds Trust and Putnam Inv. Mgmt., L.L.C.*, 403 F.3d 478, 481 (7th Cir. 2005). The Court limits its attention to § 16 of the 1933 Act, 15 U.S.C. § 77p, because the additions to the 1934 Act are functionally identical.

²² 15 U.S.C. § 77p(f)(2). The term “covered class action” means: “(i) any lawsuit in which – (I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or (II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those

be maintained in any State or Federal court by any private party alleging:

(1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or

(2) that the defendant used or employed any manipulative or deceptive device or contrivance *in connection with the purchase or sale of a covered security*.²³

In addition, SLUSA renders any covered class action brought in state court removable to federal court.²⁴ According to the Second Circuit in *Dabit*, four requirements must be met in order for SLUSA to apply: “(1) the underlying suit must be a ‘covered class action’; (2) the action must be based on state or local law; (3) the action must concern a ‘covered security’; and (4) the defendant must have misrepresented or omitted a material fact or employed a manipulative or deceptive device or contrivance ‘in connection with the purchase or sale of’ that security.”²⁵ The courts were mindful that plaintiffs might seek to avoid federal jurisdiction by creatively framing their complaints in such a way as to allege that the misrepresentations were not “in connection with” the sale or purchase of stock. In response to this type of strategy, the Eighth Circuit held that under SLUSA, a plaintiff “may not avoid federal question jurisdiction and the preemption of

persons or members of the prospective class predominate over any questions affecting only individual persons or members; or (ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which (I) damages are sought on behalf of more than 50 persons; and (II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.”

²³ 15 U.S.C. § 77p(b) (emphasis added).

²⁴ *Id.* § 77p(c).

²⁵ *Dabit*, 395 F.3d at 33 (citing *Riley v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.* 292 F.3d 1334, 1342 (11th Cir. 2002)).

state law claims by artfully concealing the federal question in an otherwise well-pleaded complaint under state law.”²⁶

II. THE SEVENTH CIRCUIT’S DECISION IN *KIRCHER V. PUTNAM FUNDS TRUST AND PUTNAM INVESTMENT MANAGEMENT, L.L.C.*

In *Kircher v. Putnam Funds Trust and Putnam Investment Management, L.L.C.*, the Seventh Circuit was confronted with whether SLUSA preempted litigation in state court.²⁷ The *Kircher* plaintiffs filed claims in state court alleging that the defendant mutual funds had set their prices in such a way that left them vulnerable to arbitrageur exploitation.²⁸ Mutual funds are required to set prices at which they sell and redeem their own shares once each day.²⁹ Each of the defendant mutual fund sets the price at which they sell and redeem their own shares at 4 p.m. Eastern time each day, shortly after the New York Stock Exchange closes.³⁰ Any order that is placed before 4 p.m. is executed at that price.³¹ The mutual funds value securities at the closing price of the principal exchange or market in which the securities are traded.³² Whereas this yields a current price for domestic securities, it may produce a price that is as much as fifteen hours old for securities of foreign issuers.³³ For example, Asian markets close twelve to fifteen hours before New York, and European markets close five or six hours ahead of New York. Many securities trade on multiple markets or over the counter.³⁴ If, for example, stock in Japan moves predominantly up during the interval between the

²⁶ *Id.* at 34 (quoting *Dudek v. Prudential Sec., Inc.*, 295 F.3d 875, 879 (8th Cir. 2002)).

²⁷ 403 F.3d 478, 480 (7th Cir. 2005).

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.*

closing of the Asian market and the closing of the New York market, the mutual fund would carry a 4 p.m. price below what would be justified by the latest available information.³⁵ Arbitrageurs could take advantage of this discrepancy by purchasing the shares of the foreign stock before 4 p.m. and then selling that stock for profit the following day.³⁶

The *Kircher* plaintiffs framed their complaints to avoid any allegations of purchase or sale.³⁷ All but one of the classes were defined as investors who held shares of a given mutual fund during the class period.³⁸ The plaintiffs alleged that the mutual funds acted recklessly in failing to prevent arbitrageurs from reaping the profits described above.³⁹ The plaintiffs argued that the mutual funds could have taken such precautions by levying fees on short-swing transactions,⁴⁰ adopting to a front-end-load charge,⁴¹ reducing the number of trades any investor can execute (or deferring each trade by one day), or valuing the securities of foreign issuers at the most current price in *any* competitive market, and not just the closing price on the issuers' home stock exchanges.⁴²

The defendant mutual funds removed the suits to federal court and moved the court to dismiss the claims under SLUSA.⁴³ Instead of dismissing the claims, the district court remanded each of the lawsuits, and the mutual funds appealed.⁴⁴ Despite the plaintiffs' claims that they only held shares during the relevant class period, the Seventh

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* at 482.

³⁸ *Id.*

³⁹ *Id.* at 481.

⁴⁰ Fees imposed on a corporate insider for a purchase or sale of company stock within a six-month period. BLACK'S LAW DICTIONARY 1413 (8th ed. 2004).

⁴¹ Mutual fund that charges a commission when shares are purchased. BLACK'S LAW DICTIONARY 1043 (8th ed. 2004).

⁴² *Kircher*, 403 F.3d at 481.

⁴³ *Id.*; 15 U.S.C. § 77p (2000).

⁴⁴ *Kircher*, 403 F.3d at 481.

Circuit found that allegations of purchases and sales were implicit in the complaint and that the plaintiffs were merely trying to evade SLUSA.⁴⁵ In deciding whether SLUSA blocked litigation in state court, the Seventh Circuit held that the “in connection with” language of SLUSA was as broad as the parallel language in § 10(b) of the Securities Exchange Act of 1934 and its corresponding regulation, Rule 10b-5.⁴⁶ Therefore, because the plaintiffs’ claims satisfied SLUSA, they were preempted from litigating their claims in state court.⁴⁷ The court further held that the purchaser-seller rule announced in the Supreme Court case *Blue Chip Stamps* did not restrict the coverage of SLUSA.⁴⁸ As a result, the plaintiffs’ claims did not fall outside the ambit of the federal securities laws, and therefore, their claims were to be left to public enforcement or litigated as derivative actions instead.⁴⁹ The problem with this outcome is that an action brought by public prosecutors or as a derivative action would grant no financial relief to the plaintiffs individually. Rather, any relief granted would be diverted to the government or a corporation.

III. THE HEART OF THE ISSUE: HOW *BLUE CHIP STAMPS V. MANOR DRUG STORES* IMPACTS THE SCOPE OF SLUSA

⁴⁵ *Id.* at 482 (finding that some plaintiffs must have purchased or increased their interest during the class period and that others “undoubtedly” sold some or all of their shares during the class period).

⁴⁶ *Id.* at 483-84 (citing 15 U.S.C. § 77p; 15 U.S.C. § 78j (2000); 17 C.F.R. § 240.10b-5 (2005)). The pertinent part of § 10(b) states: “It shall be unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78j. The pertinent part of Rule 10b-5 states: “It shall be unlawful for any person . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.” 17 C.F.R. § 240.10b-5.

⁴⁷ *Id.* at 484.

⁴⁸ *Id.* at 482-83 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)).

⁴⁹ *Id.* at 484.

Well before the PSLRA or SLUSA were enacted, the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores* decided the question of whether a plaintiff may maintain a private cause of action under Rule 10b-5 of the Securities and Exchange Commission, despite the fact that they had neither purchased nor sold any securities.⁵⁰ In that case, the plaintiffs, comprising a company that provided stamps to retailers and nine retailers who owned 90% of its shares, alleged that the defendant Blue Chip Stamp Co. had prepared and distributed a prospectus containing a “materially misleading and overly pessimistic” appraisal of the company.⁵¹ The plaintiffs claimed that this prospectus was issued in order to discourage plaintiffs from buying Blue Chip shares so that the defendant could later sell the shares to the public at a higher price.⁵² The Court held that the plaintiffs did not have standing to bring this cause of action under Rule 10b-5 because such actions were limited by the purchaser-seller rule: only actual sellers and purchasers of securities may bring a private damages action under federal securities law.⁵³

Because of the purchaser-seller rule articulated in *Blue Chip Stamps*, plaintiffs have tried to circumvent SLUSA—and thus avoid federal court—by framing their complaints to avoid allegations that they purchased or sold securities as a result of the defendant’s fraudulent conduct.⁵⁴ For example, in *Pacific Life Insurance Co. v. Spurgeon*, the plaintiffs defined the class as those investors who held the defendant’s securities during the class period but who did not purchase or sell shares during that period.⁵⁵ Under the purchaser-seller rule of *Blue Chip Stamps*, the plaintiffs would not be able to

⁵⁰ *Blue Chip Stamps*, 421 U.S. at 725.

⁵¹ *Id.* at 725-26.

⁵² *Id.* at 26.

⁵³ *Id.* at 730-31 (citing *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952)).

⁵⁴ See *Kircher*, 403 F.3d at 482.

⁵⁵ *Id.* at 483.

maintain this as a Rule 10b-5 action.⁵⁶ The defendants removed the case to federal court, but the district court remanded the case to state court.⁵⁷

As a result of these proceedings, the *Kircher* plaintiffs argued that once a private action is untenable under *Blue Chip Stamps* for failing to meet the standing requirements, that action is accordingly unaffected by SLUSA.⁵⁸ The *Kircher* plaintiffs' argument makes sense. Because the *Spurgeon* class defined itself as those who neither sold nor purchased shares, it failed to meet the standing requirement announced in *Blue Chip Stamps*.⁵⁹ Likewise, because the class members neither sold nor purchased shares, it failed the "in connection with the purchase or sale" requirement of SLUSA.⁶⁰ Therefore, SLUSA should not apply to cases in which plaintiffs, such as the *Kircher* class, merely held their securities.⁶¹

Instead of following this reasoning, the Seventh Circuit explored the actual meaning of SLUSA's "in connection with" language.⁶² It compared the parallel language in §10(b) and Rule 10b-5 and held that because all three statutes use the same language, SLUSA has the same scope as §10(b) and Rule 10b-5.⁶³ That said, the court looked to the meaning of "in connection with the purchase or sale" under the federal securities laws to determine its meaning under SLUSA.⁶⁴ It concluded that the invocation of §10(b) "does not depend on proof that the agency or United States purchased or sold securities; instead the 'in

⁵⁶ *Id.*

⁵⁷ *Id.* (citing *Pac. Life Ins. Co. v. Spurgeon*, 319 F. Supp. 2d 1116, 1126 n. 5 (C.D. Cal. 2004)). In *Spurgeon*, the district court held that jurisdiction was lacking over Pacific Life's declaratory action claiming non-liability under federal securities laws because such a federal claim only arose as a defense to a state-created action of breach of fiduciary duty.

⁵⁸ *Id.*

⁵⁹ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975).

⁶⁰ *Kircher*, 403 F.3d at 483.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

connection with' language ensures that the fraud occurs in securities transactions rather than some other activity."⁶⁵

This reasoning allowed the Seventh Circuit to dismiss the import of *Blue Chip Stamps*. It rejected the argument that *Blue Chip Stamps* limited federal securities actions to situations in which the plaintiff traded securities.⁶⁶ Rather, the *Blue Chip Stamps* purchaser-seller rule did *not* restrict coverage of SLUSA.⁶⁷ It therefore held that "limitations on private rights of action to enforce § 10(b) and Rule 10b-5 do not open the door to litigation about securities transactions under state law."⁶⁸

In addition to disregarding the application of the purchaser-seller rule of *Blue Chip Stamps* to SLUSA, the court also disregarded the Supreme Court's holding as to the proper recourse for a plaintiff who has merely held securities during the class period. Under *Blue Chip Stamps*, a case in which the plaintiff fails to buy or sell securities during the class period is not one that falls within the ambit of the PSLRA, and therefore it is not one that should be brought in federal court under federal question jurisdiction.⁶⁹ Rather, such plaintiffs should instead seek a remedy in state courts.⁷⁰ Without looking at the legislative history or congressional intent behind SLUSA, the *Kircher* court decided that instead of being relegated to state court, such plaintiffs would have to litigate the action as a derivative action or commit the claim to the SEC.⁷¹ This result undermines the purpose of

⁶⁵ *Id.*

⁶⁶ *Id.* "*Blue Chip Stamps* came out as it did *not* because § 10(b) and Rule 10b-5 are limited to situations in which the plaintiff itself traded securities, but because a private right of action to enforce these provisions is a judicial creation and the Court wanted to confine these actions to situations where litigation is apt to do more good than harm" (emphasis added).

⁶⁷ *Id.*

⁶⁸ *Id.* at 484.

⁶⁹ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754 (1975).

⁷⁰ *Id.* at 738 n.9

⁷¹ *Kircher*, 403 F.3d at 484.

SLUSA, which was to target “only those claims that were meant to be brought in federal court subject to the PSLRA’s restrictions.”⁷²

In *Kircher*, the Seventh Circuit alluded that it was agreeing with its sister circuits who were confronted with similar claims by stating that it, too, found that the scope of SLUSA’s coverage tracked that of §10(b) and Rule 10b-5.⁷³ However, the court failed to note that its sister circuits *did* find that the purchaser-seller rule of *Blue Chip Stamps* limited SLUSA and that in cases where the plaintiffs failed the *Blue Chip Stamps* standing requirement, the case should be brought in state court.⁷⁴ By bypassing the significance of *Blue Chip Stamps*, the Seventh Circuit concluded that the purchaser-seller rule did not affect SLUSA and that even in situations where the plaintiff did not buy or sell securities, the case still could not be brought in state court.⁷⁵ Rather, the case must be brought as a derivative action or committed to public prosecutors.⁷⁶

IV. COMPARING *KIRCHER* WITH ITS SISTER CIRCUITS

The first circuit to compare the scope of SLUSA with §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 was the Eighth Circuit in *Green v. Ameritrade, Inc.* in February, 2002.⁷⁷ In *Green*, the plaintiff filed its original complaint in state court alleging that subscribers to the defendant’s Real-Time program made investment decisions to purchase or sell options based on information that the defendant provided.⁷⁸ The defendant removed the action to federal

⁷² *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 42 (2d Cir. 2005).

⁷³ *Kircher*, 403 F.3d at 483-84.

⁷⁴ *See e.g., Dabit*, 395 F.3d at 40; *Green v. Ameritrade, Inc.*, 279 F.3d 590, 598-99 (8th Cir. 2002).

⁷⁵ *Kircher*, 403 F.3d at 483.

⁷⁶ *Id.* at 484.

⁷⁷ 279 F.3d at 597-98.

⁷⁸ *Id.* at 593-94. The Real Time service provided subscribers with real time stock price information with one click of a button.

court and moved to dismiss the action as preempted by SLUSA.⁷⁹ Instead of dismissing the action, the court gave the plaintiff 35 days to amend his complaint.⁸⁰ In his amended complaint, the plaintiff avoided any reference to a purchase or sale and alleged that the defendant breached its contract when it failed to provide a certain kind of price information.⁸¹ The district court held that SLUSA did not preempt the plaintiff's claim, and the defendant appealed.⁸² On appeal, the Second Circuit decided whether the complaint gave rise to a federal question under the federal securities laws as opposed to a state law breach of contract claim.⁸³ In order to show preemption under SLUSA, the claim must satisfy four requirements: "(1) the action is a 'covered class action' under SLUSA, (2) the action purports to be based on state law, (3) the defendant is alleged to have misrepresented or omitted a material fact (or to have used or employed any manipulative or deceptive device or contrivance), and (4) the defendant is alleged to have engaged in conduct described by criterion 'in connection with' the purchase or sale of a 'covered security.'"⁸⁴

The Eighth Circuit relied on the rule announced in *Blue Chip Stamps* that a cause of action under Rule 10b-5 required that the plaintiff either purchased or sold the securities at issue.⁸⁵ The court was not persuaded by the defendant's argument that the language "in connection with" should be interpreted with flexibility, stating that Congress had "specifically rejected suggestions to broaden the scope of the statute to include mere attempts to purchase or sell a security."⁸⁶ In reconciling *Blue Chip Stamps* with SLUSA, the court held that non-

⁷⁹ *Id.* at 594.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.* at 596.

⁸⁴ *Id.* The district court only found that defendant failed to meet the third requirement. *Id.* at n.5.

⁸⁵ *Id.* at 597.

⁸⁶ *Id.*

sellers and non-purchasers were not preempted by SLUSA.⁸⁷ Despite having knowledge that the plaintiff's original complaint alleged fraud in connection with the sale or purchase of securities, the court did not conclude that sales or purchases were implied in the plaintiff's amended complaint, which avoided any reference to purchases or sales of securities.⁸⁸ It seems as though the court knew that the plaintiff was attempting to evade SLUSA and that the district court, in granting an extension to file an amended complaint, actually encouraged an artful crafting of the complaint in order to remain in state court.

On the other hand, the Seventh Circuit in *Kircher* found that the sale and purchase of securities were implied in the plaintiffs' allegations, despite having any evidence of the sort that the *Green* court did.⁸⁹ Another contrast between *Kircher* and *Green* is how they interpreted the effect of SLUSA preemption. Whereas the *Kircher* court held that the claims of plaintiffs who did not trade would be left to public enforcement, the *Green* court held such claims should be remanded to state court.⁹⁰

Shortly after *Green* was decided, in June 2002, the Eleventh Circuit addressed the scope of SLUSA in *Riley v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*⁹¹ In *Riley*, the trustees of the Performance Toyota, Inc. Profit Sharing Plan ("Performance Plan") and the trustee of the Master Packaging, Inc. 401(k) plan ("Master Packaging") filed a class action in federal court against the defendant alleging securities fraud in connection with the purchase and retention of shares under Florida law.⁹² The Performance Plan plaintiffs then moved to dismiss itself from the federal court action and re-filed its case in state court.⁹³ Pursuant to SLUSA, the defendant removed

⁸⁷ *Id.* at 598.

⁸⁸ *Id.* at 593-93, 598.

⁸⁹ *Kircher v. Putnam Funds Trust and Putnam Inv. Mgmt., L.L.C.*, 403 F.3d 478, 402 (7th Cir. 2005).

⁹⁰ *Id.* at 484; *Green*, 279 F.3d at 599.

⁹¹ 292 F.3d 1334 (11th Cir. 2002).

⁹² *Id.* at 1336.

⁹³ *Id.*

these plaintiffs back to federal court, and the plaintiffs subsequently moved to remand the action to state court.⁹⁴ The district court denied the plaintiffs' motion and dismissed both the Performance Plan and Master Packaging complaints under SLUSA and for lack of diversity jurisdiction.⁹⁵ The plaintiffs appealed.⁹⁶

With respect to the Performance Plan plaintiffs, the Eleventh Circuit had to determine whether SLUSA applied to their claims.⁹⁷ The court first assessed the scope of the "in connection with" language of SLUSA as it compares to the parallel language of § 10(b) and Rule 10b-5.⁹⁸ The court analogized SLUSA to the latter federal securities laws because SLUSA was enacted as an amendment to the 1933 and 1934 Acts.⁹⁹ In essence, when enacting SLUSA, "Congress was not writing on a blank slate; instead, it was legislating in an area that had engendered tremendous amounts of litigation and received substantial judicial attention."¹⁰⁰ In addition to relying on *Blue Chip Stamps* for the rule that SLUSA does not govern claims based solely on the retention of securities, the Eleventh Circuit cited a more recent case, *Gutierrez v. Deloitte & Touche, L.L.P.*¹⁰¹ The court in *Gutierrez* held that SLUSA did not cover the plaintiffs' claim that the defendant's acts caused them to hold securities that they otherwise would have sold.¹⁰² With respect to the Performance Plan plaintiffs, however, SLUSA did apply because the plaintiffs had alleged not only that the defendant's misrepresentations caused them to retain their shares, but to purchase them, as well.¹⁰³ The Eleventh Circuit agreed with the *Gutierrez* court

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.* at 1340.

⁹⁸ *Id.* at 1342.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 1343. (citing *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 592 (W.D. Tex. 2001)).

¹⁰² *Id.* at 1344 (citing *Gutierrez*, 147 F. Supp. 2d at 592).

¹⁰³ *Id.* at 1345 (citing *Gutierrez*, 147 F. Supp. 2d at 592).

that plaintiffs with retention claims were entitled to bring their claims in state court.¹⁰⁴

By contrast, the Seventh Circuit did not permit the *Kircher* plaintiffs to pursue their retention claim in state court.¹⁰⁵ Rather, according to the Seventh Circuit, the anti-fraud securities laws do not require proof of purchase or sale, and therefore the court may imply such in a plaintiff's retention claim.¹⁰⁶ Even if the court chose to believe that the *Kircher* class contained only non-purchasers and non-sellers, state court would not be a viable alternative.¹⁰⁷

A few months later, in October 2002, the Ninth Circuit addressed the same issue as to whether state law fraud claims were preempted by SLUSA in *Falkowski v. Imation Corp.*¹⁰⁸ In *Falkowski*, the plaintiffs filed suit in state court alleging breach of contract and fraud in connection with their employee stock options.¹⁰⁹ Specifically, the defendant company and its executives had granted stock options to the plaintiffs, and the plaintiffs alleged that the defendants induced them to remain with the company by misrepresenting the value of the stock and options.¹¹⁰ The defendants removed the case to federal court, and the district court held that removal was proper because the plaintiffs' claims were preempted by SLUSA.¹¹¹ The plaintiffs appealed.¹¹²

After concluding that the company's stock qualified as a "covered security" under SLUSA, the Ninth Circuit analyzed whether the alleged misrepresentations were "in connection with the purchase or sale" of the defendants' stock.¹¹³ Citing to *Blue Chip Stamps*, the court

¹⁰⁴ *Id.* at 1345.

¹⁰⁵ *Kircher v. Putnam Funds Trust and Putnam Inv. Mgmt., LLC, et al.*, 403 F.3d 478, 483-84 (7th Cir. 2005).

¹⁰⁶ *Id.* at 483.

¹⁰⁷ *Id.* at 483-84.

¹⁰⁸ 309 F.3d 1123 (9th Cir. 2002).

¹⁰⁹ *Id.* at 1127.

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* at 1129.

held that the mere grant of an employee stock option was in and of itself a “sale” of that covered security, and therefore the plaintiffs’ claims satisfied SLUSA.¹¹⁴

The Seventh Circuit in *Kircher* could have followed the reasoning of the *Falkowski* court to show that even non-traders of stock, by virtue of the fact that they held stock, constitute “purchasers” and “sellers” of securities for purposes of Rule 10b-5.¹¹⁵ The *Falkowski* court cited *Blue Chip Stamps* for the argument that under the 1933 and 1934 Acts,

[T]he holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as “purchasers” or “sellers” of securities for purposes of Rule 10b-5, not because of a judicial conclusion that they were similarly situated to “purchasers” or “sellers,” but because the definitional provisions of the 1934 Act themselves grant such status.¹¹⁶

Therefore, it is sufficient that a person merely contracts to sell a security, even if the sale is never actually consummated, for the conduct to fall within the ambit of the 1933 and 1934 Acts.¹¹⁷ The court squarely held that when a company grants an employee stock option, that is a “sale” of that covered security, regardless of whether or not the employee chooses to exercise the option.¹¹⁸

Accordingly, the Seventh Circuit in *Kircher* could have made the more compelling argument that SLUSA nevertheless pre-empted the plaintiffs’ claims despite the fact that the class members never actually

¹¹⁴ *Id.* at 1129-30.

¹¹⁵ *Id.* at 1129.

¹¹⁶ *Id.*

¹¹⁷ *Id.* The *Falkowski* court refers to this as the “aborted purchaser-seller doctrine.” *Id.*

¹¹⁸ *Id.* at 1129-30. The court did, however, place some limitation on the scope of this language, such that there must be “more than some tangential relation” between the fraud and stock sale. *Id.* at 1131.

traded. Instead, the court assumed that some investors must have purchased their interest during the class period and some members who owned stock at the beginning of the period must have sold some or all of their stock during the period.¹¹⁹ Therefore, the Seventh Circuit concluded that many class members had engaged in the purchase and/or sale of their stock.¹²⁰

The last Circuit to address this issue was the Second Circuit in the case *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*¹²¹ In *Dabit*, the plaintiff filed a class action lawsuit in district court on diversity grounds alleging that the defendant issued biased research and investment recommendations in order to obtain investment banking business, a violation of state law.¹²² The district court dismissed the case under Federal Rule of Civil Procedure 12(b)(6), as the case was preempted by SLUSA.¹²³ Like the plaintiffs in *Kircher*, the plaintiff in *Dabit* argued that SLUSA did not preempt his actions because the allegations did not involve misrepresentations or omissions of material fact “in connection with the purchase or sale of . . . covered securit[ies].”¹²⁴ Rather, the *Dabit* plaintiff sought damages incurred when the defendant fraudulently induced him to hold certain securities and for lost commissions as a result of recommending securities based on the defendant’s false research reports.¹²⁵

Following the Eleventh Circuit’s reasoning in *Riley*,¹²⁶ the Second Circuit held that meaning of “in connection with” under SLUSA had

¹¹⁹ *Kircher v. Putnam Funds Trust and Putnam Inv. Mgmt., L.L.C.*, 403 F.3d 478, 482 (7th Cir. 2005).

¹²⁰ *Id.*

¹²¹ 395 F.3d 25 (2d Cir. 2005).

¹²² *Id.* at 28-30. The plaintiffs filed this class action in the United States District Court for the Western District of Oklahoma, and the Judicial Panel for Multidistrict Litigation subsequently transferred the case to the Southern District of New York.

¹²³ *Id.* at 28.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1342 (11th Cir. 2002).

the same scope as the similar language of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.¹²⁷ In addition, there was nothing in the statute's text or legislative history to overcome the presumption that when Congress adopted SLUSA, which incorporated the language of § 10b and Rule 10b-5, it simultaneously adopted the judicial interpretation of that language in § 10(b) and Rule 10b-5.¹²⁸ The *Dabit* court dismissed the defendant and SEC's argument that the purchaser-seller rule announced in *Blue Chip Stamps* was irrelevant to whether a claim was preempted by SLUSA.¹²⁹ For, although *Blue Chip Stamps* provides a federal remedy only to purchasers and sellers of stock, non-purchasers and non-sellers could still seek a remedy under state law.¹³⁰ Therefore, the Second Circuit conceded that the purchaser-seller rule limits SLUSA's "in connection with" requirement, and thus it does not preempt claims in which the plaintiffs deny having purchased or sold securities during the relevant class period.¹³¹ However, the court held that *Dabit*'s claim nevertheless satisfied SLUSA because it implicitly alleged purchases made by plaintiff and putative class members.¹³² Significantly, the court remanded the case with instructions to dismiss the claims without prejudice, in order to allow the plaintiff to plead a claim under state law.¹³³

¹²⁷ *Dabit*, 395 F.3d at 28.

¹²⁸ *Id.* at 36.

¹²⁹ *Id.* at 39.

¹³⁰ *Id.* at 40 (citing *Blue Chip Stamps et al. v. Manor Drug Stores*, 421 U.S. 723, 738 n.9 (1917)).

¹³¹ *Id.* "There is no clear support in the legislative history for the conclusion that Congress intended SLUSA to preempt claims that do not satisfy the *Blue Chip* rule." *Id.* at 41. "[W]e hold that in enacting SLUSA Congress sought only to ensure that class actions brought by plaintiffs who satisfy the *Blue Chip* purchaser-seller rule are subject to federal securities laws." *Id.* at 43.

¹³² *Id.* at 40, 46 (finding that the entire claim should be dismissed because the class included members who relied on misleading or fraudulent "buy recommendations," therefore satisfying the "in connection with" requirement for SLUSA preemption.).

¹³³ *Id.* at 47.

By contrast, the Seventh Circuit in *Kircher* reasoned that the standing requirement in *Blue Chip Stamps* did not mean that the claims of non-purchasers and non-sellers fell outside of § 10(b) and Rule 10b-5 and into state court but rather that such claims were to be left to public enforcement.¹³⁴ While both the *Kircher* and *Dabit* courts ultimately concluded that purchases and sales were implicit in the plaintiffs' allegations, had they not reached this conclusion, the *Dabit* court would have found that SLUSA did not preempt the plaintiff's claims, and therefore the case must be decided under state law.¹³⁵ Alternatively, the *Kircher* court would have required the plaintiffs to litigate their claim as either a derivative action in federal court or to commit the case to public prosecutors.¹³⁶

The Second Circuit in *Dabit* squarely held that the *Blue Chip Stamps*' purchaser-seller rule applied to the construction of the "in connection with" language under SLUSA whereas the Seventh Circuit in *Kircher* held that *Blue Chip Stamps* did not restrict coverage of SLUSA.¹³⁷ *Dabit* declares that while the purpose of SLUSA may be to prevent plaintiffs from seeking to evade federal law by filing in state court, this would only preempt claims "that could have been brought in federal court to begin with."¹³⁸ Under *Blue Chip Stamps*, a plaintiff's claim of fraud that is *not* in connection with the purchase or sale of a security is not one which could be brought in federal court.¹³⁹ Therefore, although the language "in connection with" tracks the similar language in § 10b and Rule 10b-5, a federal court must first determine whether the putative class includes purchasers or sellers before deciding whether the claim is preempted by SLUSA.¹⁴⁰

¹³⁴ *Kircher v. Putnam Funds Trust and Putnam Inv. Mgmt., L.L.C.*, 403 F.3d 478, 484 (7th Cir. 2005).

¹³⁵ *Id.* at 482; *Dabit*, 395 F.3d at 40.

¹³⁶ *Kircher*, 403 F.3d at 484.

¹³⁷ *Id.* at 483; *Dabit*, 359 F.3d at 50-51.

¹³⁸ *Dabit*, 395 F.3d at 41-42 (emphasis added).

¹³⁹ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1917).

¹⁴⁰ *Dabit*, 395 F.3d at 42-43.

V. CONCLUSION

In 1975, the Supreme Court decided *Blue Chip Stamps*, holding that a plaintiff must have purchased or sold securities in order to have standing for a Rule 10b-5 claim.¹⁴¹ In the alternative, a plaintiff who claimed that he merely held securities and thus lacked standing must file a state-law securities fraud claim in state court.¹⁴² Thirty years later in *Kircher*, the Seventh Circuit concluded that the purchaser-seller rule announced in *Blue Chip Stamps* did not affect the impact of SLUSA, which limits certain class actions under state law where the plaintiff alleges securities fraud “in connection with the purchase or sale of a covered security.”¹⁴³ Rather, the Seventh Circuit, fearful that plaintiffs were trying to evade SLUSA and thus federal court jurisdiction, read beyond the complaint to imply that the plaintiffs must have purchased or sold securities during the class period.¹⁴⁴ Furthermore, the court held that even had the class consisted of non-purchasers and non-sellers, the proper recourse would be to commit the case to public prosecutors or file a derivative action as opposed to litigating the claim in state court.¹⁴⁵

The Seventh Circuit alluded that it was following the reasoning of its sister circuits by deciding that SLUSA’s coverage was as broad as the scope of private damages under Rule 10b-5.¹⁴⁶ However, the court departed from decisions by the Eighth, Eleventh, and Second Circuits in concluding that even non-purchasers and non-sellers were preempted by SLUSA and that the proper recourse was not to file in

¹⁴¹ *Blue Chip Stamps*, 421 U.S. at 730-31.

¹⁴² *Id.* at 738 n.9.

¹⁴³ 15 U.S.C. § 77p(b) (2000); *Kircher v. Putnam Funds Trust and Putnam Inv. Mgmt. L.L.C.*, 403 F.3d 478, 483 (7th Cir. 2005).

¹⁴⁴ *Kircher*, 403 F.3d at 482.

¹⁴⁵ *Id.* at 484.

¹⁴⁶ *Id.* at 483-84.

state court but rather to leave the case to public prosecutors or file a derivative action.¹⁴⁷

Perhaps the Seventh Circuit was so harsh on the *Kircher* plaintiffs by refusing to lend credence to the *Blue Chip Stamps* purchaser-seller rule because it was frustrated by what it thought was the plaintiffs' attempt to evade federal court. The court stated:

[P]laintiffs' claims depend on statements made or omitted in connection with *their own* purchases of the funds' securities . . . Indeed, most of the approximately 200 suits filed against mutual funds in the last two years alleging that the home-exchange-valuation rule can be exploited by arbitrageurs have been filed in federal court under Rule 10b-5. Our plaintiffs' effort to define non-purchaser-non-seller classes is designed to evade PSLRA in order to litigate a securities class action in state court in the hope that a local judge or jury may produce an idiosyncratic award. It is the very sort of maneuver that SLUSA is designed to prevent.¹⁴⁸

The Seventh Circuit's decision in *Kircher* impacts the use of the federal court's jurisdictional powers. By allowing SLUSA to preempt securities actions in which the plaintiff merely held as opposed to purchased or sold securities, the Seventh Circuit has expanded federal jurisdiction and limited state court jurisdiction. Perhaps this decision was the Seventh Circuit's way of curbing abuses of federal securities fraud litigation by preventing plaintiffs from evading federal court and avoiding the heightened standards imposed by the PSLRA. While having suspicions about potentially meritless securities class actions is justified, the *Kircher* opinion may have gone too far. For, the Seventh Circuit's decision effectively limits

¹⁴⁷ *Id.* at 484 (stating that, "[b]y depicting their classes as containing entirely non-traders, plaintiffs do not take their claims outside § 10(b) and Rule 10b-5").

¹⁴⁸ *Id.*

plaintiffs' remedies. If their case is preempted by SLUSA, despite the fact that they did not purchase or sell securities, they are required to hand over their case to the SEC or pursue their claim as a derivative action. As a result, plaintiffs are unable to obtain monetary relief for themselves, individually.