Merrill Lynch et al. v. Manning: U.S. Supreme Court Removes Arrow in the Quiver of Defendants Seeking to Litigate State Securities Lawsuits in Federal Court

BACKGROUND

Investors who prefer to litigate their securities-related lawsuits in state court under plaintiff-friendly state securities laws just landed a significant victory.

On May 16, 2016, in a unanimous ruling, the U.S. Supreme Court held that the jurisdictional provision in the Securities Exchange Act of 1934 (the "Exchange Act"),[1] which says that federal courts have exclusive jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act]," is subject to the same jurisdictional test used to determine if a case "arises under" federal law under 28 U.S.C. § 1331.

In the underlying case, the plaintiff, owner of over two million shares of stock in a company traded on the NASDAQ exchange, alleged that Merrill Lynch had engaged in the practice of "short selling" stock.[2] The complaint asserted a series of state statutory and common law claims, including violations of the New Jersey Racketeer Influenced and Corrupt Organizations Act ("RICO"), state securities laws, and an assortment of common law claims such as negligence, unjust enrichment, and interference with contractual relations. Merrill Lynch, the defendant, removed the matter to federal court, pursuant to 28 U.S.C. § 1441, arguing that the federal court could exercise jurisdiction over the plaintiff's state-law claims because the claims arose under federal law – as required by § 1331,[3] and because § 27 of the Exchange Act gives federal courts exclusive jurisdiction over cases "*brought to enforce* any liability or duty created by" the Exchange Act. The plaintiff moved to remand the matter to state court, and the district court denied the motion.

The Third Circuit reversed, holding that the state-law claims did not "arise under" federal law such that jurisdiction would be appropriate under § 1331. The Court also ruled that the district court did not have jurisdiction under § 27 of the Exchange Act, because the terms "*brought to enforce* any liability or duty created by" the Exchange Act conferred federal jurisdiction over claims that "arise under" the Exchange Act, as the terms "arise under" are interpreted in the context of determining whether federal jurisdiction is appropriate under § 1331.

The Supreme Court affirmed, holding that "the jurisdictional test established by [§27 of the Exchange Act] is the same as the one used to decide if a case 'arises under' a federal law." In reaching this conclusion, the Court clarified that § 27 confers federal jurisdiction only "when an action is commenced in order to give effect to an Exchange Act requirement." Thus, the Court stated, state

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[1] 48 Stat. 992, as amended, 15 U.S.C. § 78a, *et seq.*

[2] The practice of "short selling" allows a securities trader to profit from the decrease in the price of stock by borrowing shares, selling them, and then subsequently repurchasing the shares at a later date when the stock price drops.

[3] Often referred to as "federal question jurisdiction," Section 1331 gives federal district courts jurisdiction to preside over "all civil actions *arising under* the Constitution, laws, or treaties of the United States." 28 U.S.C. § 1331 (emphasis added).

common law claims (such as breach of contract claims) do not give rise to federal jurisdiction under § 27 simply because they "happen[ ] to mention a duty established by the Exchange Act." Where, the Court held, the plaintiff may obtain "all the relief he seeks . . . without proving any violation of federal securities law," the lawsuit is not one that is "brought to enforce" a duty or liability under the Exchange Act.

IMPLICATIONS FOR LOCAL INDIVIDUALS AND COMPANIES

This ruling has at least two immediate implications for companies and individuals in Hawaii. First, *Manning* changed the law in Hawaii. Existing Ninth Circuit precedent provides that a lawsuit alleging only state-law claims, based on conduct that violates federal securities law, is a lawsuit that falls within the scope of § 27.[4] *Manning* squarely overrules this precedent.

Second, *Manning* opens the door for private parties, and Hawaii's Commissioner of Securities, to litigate state securities violations on their own turf, where they may prefer to fight complex securities cases. At present, there are a variety of common law claims that private parties may assert in Hawaii, based on conduct that would also constitute a violation of the Exchange Act, such as breach of contract, intentional misrepresentation, and unjust enrichment, to name a few. Moreover, like New Jersey, Hawaii has a securities statute, the Uniform Securities Act,[5] which could potentially be used as a vehicle for the Commissioner of Securities to assert claims against companies or individuals for conduct that also violates federal securities law. Thus, both private litigants and state regulators may use *Manning* to ensure that their state-law claims remain in state court, which they may view as a more advantageous forum.

More broadly, the Supreme Court's ruling allows state courts to create a patchwork of law governing securities transactions. While this concern may not be significant for entities in Hawaii regulated by the Uniform Securities Act, due to the fact that Hawaii courts can (and do) look to federal courts for guidance in interpreting the Uniform Securities Act,[6] individuals and companies in Hawaii should be mindful that factual findings in state securities lawsuits may have a preclusive effect in future SEC enforcement actions. Moreover, as a practical matter, adverse factual findings in state securities-related cases may make it difficult for defendants in such cases to deny unlawful conduct during an SEC civil action in federal court or an administrative proceeding, or during settlement negotiations.

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[4] *See Sparta Surgical Corp. v. National Ass'n of Securities Dealers, Inc.*, 159 F.3d 1209, 1212 (1998) (holding that, under § 27 of the Exchange Act, district court could exercise jurisdiction over claims brought by plaintiff alleging only state law claims, arising out of conduct that also violated Exchange Act); *see also id.* (holding that district court had federal question jurisdiction, pursuant to § 1331, over state law claims, because, although plaintiff's theory of liability was "posited as state law claims," underlying conduct alleged in complaint involved violations of federal securities law).

[5] Hawaii Revised Statutes Chapter 485A.

[6] *See Price v. Obayashi*, 914 P.2d 1364, 1374 (1996) (noting that "in instances where Hawai'i case law and statutes are silent, this court can look to parallel federal law for guidance").

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