The Supreme Court and the Federalization of Corporate Law

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1) Introduction

   a) Skepticism over federal litigation.

      i) Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (private cause of action limited to purchasers and sellers of securities: the concern over "vexatious litigation").

      ii) Dirks v. SEC, 463 U.S. 646, 665 (1983) (holding that an analyst who passed along material nonpublic information about a public company to his clients did not violate Rule 10b-5 because he did not receive the information from someone who breached his fiduciary duty to the public company).

      iii) Marine Bank v. Weaver, 455 U.S. 551, 555 (1982) (holding that neither a bank certificate of deposit nor a private profit sharing arrangement was a security).

      iv) Chiarella v. United States, 445 U.S. 222, 235 (1980) (purchasing securities based on nonpublic information does not violate Rule 10b-5 because the purchaser had no common law duty of disclosure to the sellers).

v) Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 570 (1979) (finding that a noncontributory, compulsory pension plan is not an investment contract and therefore not a security).

vi) Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475-76 (1977) (ruling that breach of fiduciary duty cannot be the basis for a claim under Rule 10b-5; the plaintiff must allege and prove that the defendant engaged in manipulative or deceptive conduct to state a claim under the Rule).

vii) Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (holding that negligence cannot be the basis for an action under Rule 10b-5 and that the plaintiff must allege and prove scienter).

viii) Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995) (holding that the remedy under section 12(a)(2) of the Securities Act of 1933 is limited to purchasers of securities in a public offering by an issuer or a controlling shareholder of the issuer).

b) Culmination: Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994) (holding that there is no basis for aider and abettor liability under Rule 10b-5).

c) Common theme: the role of state law. Epitomized in Santa Fe Industries v. Green.

d) Theme echoed in insider trading cases of Chiarella and Dirks.

e) The Court reverses course – United States v. O'Hagan, 521 U.S. 642 (1997); Wharf (Holdings) Ltd. v. United International Holdings, Inc., 532 U.S. 588

(2001); SEC v. Edwards, 540 U.S. 389 (2004); SEC v. Zandford, 540 U.S. 389 (2004) – thus raising questions about the "new federalism."

2) The Court's Early Decisions

   a) An expanded view of implied rights of action: J.I Case v. Borak, 377 U.S. 426 (1964).

   b) Burger Court reaction: Cort v. Ash, 422 U.S. 66, 78 (1975): "In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff "one of the class for whose especial benefit the statute was enacted,"—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?"

   c) Cort and Blue Chip Stamps cut from the same cloth.

   d) Santa Fe, decided in 1977, emphasized state law as an alternative to a Rule 10b-5 claim for breach of fiduciary duty by directors.

   e) State law also a factor in: Piper v. Chris-Craft Industries, Inc., 430 U.S. 1 (1977)(unsuccessful tender offeror denied standing under § 14(e) of the Williams Act); Burks v. Lasker, 441 U.S.471 (1979)(state law determines whether board of federally regulated investment company has authority to terminate shareholder derivative action alleging violations of federal securities laws).

3) A New Approach?: The O'Hagan, Wharf, Zandford, and Edwards cases.

   a) O'Hagan: reading the "in connection with" language broadly.

   b) Zandford: ditto in a garden variety breach of fiduciary duty.

   c) Wharf: applying the federal securities laws to a breach of contract action.

   d) Edwards: and un-nuanced application of the definition of a security.

      i) Blunt application of SEC v. W.J. Howey, 328 U.S. 293 (1946), ignoring the "common enterprise" requirement.

4) Federalism and Corporate Law

   a) The "new federalism" represented by U.S. v. Lopez, 514 U.S. 549 (1995) and U.S. v. Morrison, 529 U.S. 598 (2000) – do those cases really represent a rejection of a long line of cases expanding federal authority? Consider the expanding reach of:

      i) the Federal Arbitration Act: Southland Corp. v. Keating, 465 U.S. 1 (1984), followed in the period of "heightened sensitivity" by Circuit City v. Adams, 532 U.S. 105 (2001);

      ii) federal statutory preemption: Geier v. American Honda Motor Co., 529 U.S. 861 (2000)(state tort law claim preempted by DOT mandate of phase-in for airbags); Crosby v. Nat'l Foreign Trade Council, 530 U.S. 363, 371 (2000) (preempting local ordinance requiring boycott of Burma); Norfolk S. Ry. Co. v. Shanklin, 529 U.S. 344, 359 (2000) (preempting state tort liability); United States v. Locke, 529 U.S. 89, 116 (2000); *see also* Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 571 (2001) (finding that state regulations governing cigarette advertising and sales preempted by Federal Cigarette Labeling and

Advertising Act); Egelhoff v. Egelhoff, 532 U.S. 141, 150 (2001) (deciding that state law providing that upon divorce beneficiary designations automatically revoked was preempted by the Employee Retirement Income Security Act of 1974); Buckman Co. v. Plaintiffs' Legal Comm., 531 U.S. 341, 353 (2001) (holding that the Federal Food, Drug, and Cosmetic Act preempts state Fraud-on-the-FDA claims); Aetna Health Inc. v. Davila, 542 U.S. 200 (2004) (finding that ERISA preempts state court suits alleging that defendant HMOs failed to exercise ordinary care under the Texas Health Care Liability Act); Engine Mfrs. Ass'n v. S. Coast Air Quality Mgmt. Dist., 541 U.S. 246, 258 (2004) (holding that California rule requiring fleet purchases to meet certain emissions requirements was preempted by Federal Clean Air Act); Pierce County, Wash. v. Guillen, 537 U.S. 129, 148 (2003) (deciding that Federal Hazard Elimination Program's evidentiary privileges apply in state court proceedings as appropriate use of the commerce clause). *But see* Sprietsma v. Mercury Marine, 537 U.S. 51, 69 (2002) (finding that state tort action based on boat manufacturers' failure to provide propeller guards was not preempted by Federal Boat Safety Act of 1971).

iii) federal constitutional preemption in punitive damages cases: Pacific Mutual Life Insurance Co. v. Haslip, 499 U.S. 1, 18 (1991)(due process clause bars excessive punitive damage awards); BMW of N. Am., Inc. v. Gore, 517 U.S. 559 (1996)(establishing guideposts for courts to follow in assessing the constitutionality of punitive damage awards); State Farm Mut. Auto. Insur. Co. Campbell, 538 U.S. 408 (2003)(establishing the "single-digit" ratio).

5) The SLUSA cases

a) An introduction to Securities Litigation Uniform Standards Act of 1998: making the Private Securities Litigation Reform Act of 1995 more effective.

b) Merrill Lynch, Pierce, Fenner & Smith v. Dabit, ___ U.S. ___, 126 S.Ct. 1503 (2006)(holders actions precluded by SLUSA).

c) Kircher v. Putnam Funds Trust, __ U.S.___, 126 S.Ct. 2145 (2006)(district court decision to remand removed action is nonappealable).

d) Does Kircher represent a counter-example? In Kircher, the Supreme Court held that a decision of the U.S. District Court to remand to state court an action that had been removed to the District Court under SLUSA was nonreviewable in accordance with 28 U.S.C. § 1447(d). Here, the District Court had determined that it lacked jurisdiction over this securities class action because it was a "holders" action and SULSA did not preclude state courts from hearing such actions (pre-Dabit). The 7th Circuit held that the order was reviewable because the decision of the District Court was "substantive," not jurisdictional, and therefore subject to appellate jurisdiction in the normal course.

In one sense, the issue of federalism is not posed by this case, because all that is decided is federal appellate jurisdiction over a narrow class of district court decisions. Even more narrowly, the Supreme Court merely interprets a federal statute dealing with a matter of pure civil procedure – the reviewability of a district court order.

There is, though, a small federalism issue lurking here. The District Court order arguably decided that SULSA does not preclude holders actions, and the

defendants argued that the determination would bind them in the state action. The Supreme Court rejected this argument, saying the state courts are free to decide this issue. The Court, however, to give a bit of direction: "[W]e have no reason to doubt that the state court will duly apply *Dabit's* holding that holder claims are embraced by [SLUSA]…" Lest the message be unclear, the Court continued, "any claim of error on that point can be considered on review by the Court." (p. 2157).

Deference to the states is thus illusory at best.