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Dabit, Preemption and Choice of Law

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## **Abstract**

The Supreme Court's decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, involves the reconciliation of three significant policy goals – controlling abusive litigation, deterring securities fraud, and preserving our federal system by limiting the federal government's power. These goals seem to conflict in that controlling litigation involves expanding federal power, thereby foreclosing potential state approaches to controlling fraud. In *Dabit*, the Court opted to broadly interpret the federal government's preemption of state securities remedies, thereby giving momentum to the federalization of corporate law. This article shows that forcing Congress to attend more closely to the role of state law might have encouraged a better reconciliation of the three policy goals. Specifically, Congress can control abusive litigation without sacrificing the states' role in remedying fraud by preserving fraud remedies imposed under state corporation laws. Letting firms choose the applicable state law would motivate states to develop reasonable remedies rather than to invite abusive litigation. A viable state fraud remedy would, in turn, free Congress and the courts to examine the appropriate extent of federal fraud remedies.



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# ***DABIT, PREEMPTION AND CHOICE OF LAW***

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### Abstract

The Supreme Court's decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, involves the reconciliation of three significant policy goals – controlling abusive litigation, deterring securities fraud, and preserving our federal system by limiting the federal government's power. These goals seem to conflict in that controlling litigation involves expanding federal power, thereby foreclosing potential state approaches to controlling fraud. In *Dabit*, the Court opted to broadly interpret the federal government's preemption of state securities remedies, thereby giving momentum to the federalization of corporate law. This article shows that forcing Congress to attend more closely to the role of state law might have encouraged a better reconciliation of the three policy goals. Specifically, Congress can control abusive litigation without sacrificing the states' role in remedying fraud by preserving fraud remedies imposed under state *corporation laws*. Letting firms choose the applicable state law would motivate states to develop reasonable remedies rather than to invite abusive litigation. A viable state fraud remedy would, in turn, free Congress and the courts to examine the appropriate extent of federal fraud remedies.

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## I. INTRODUCTION

*Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*<sup>1</sup> finds Congress and the Supreme Court caught in the conflict of three significant policy goals. The first is the need to rein in litigation that increasingly threatens to swamp every type of business in liability and precaution costs. Second, Congress has sought to control securities fraud, particularly in the wake of the stock market collapse and revelations of fraud at Enron and other companies. The third policy goal is the need to preserve our federal system by appropriately limiting the federal government's power. Congress seemingly must expand federal power to control state courts and legislatures that seek to encourage local litigation. At the same time, controlling state fraud litigation seemingly increases the need for more federal antifraud law, further expanding federal power and shrinking the states' role in making corporate and securities laws.

By broadly interpreting Congress' preemption of state securities fraud remedies and extending the dominance of federal law, *Dabit* missed an opportunity to encourage Congress to consider how to reconcile these conflicting policy goals. This article shows that there is, in fact, a way out of the dilemma by which Congress can control abusive state and federal litigation without either unduly expanding federal power or sacrificing the states' role in remedying fraud: Congress can preserve the states' power to remedy securities fraud under their *corporation laws*. This would activate the corporate law choice of law rule that enables firms to choose the applicable state law. States then would have an incentive to develop reasonable remedies rather than to invite abusive litigation. The availability of viable state fraud remedies law would, in turn, encourage Congress and the courts to address excessive private remedies under federal law.

Part II briefly summarizes the background of the case. Parts III – V discuss the three conflicting goals identified above. Part VI shows how the *Dabit* case forced the Court to make tradeoffs among these goals. Part VII discusses the choice-of-law path out of the thicket of these policy conflicts. Part VIII concludes.

## II. BACKGROUND

The Securities and Exchange Act of 1934 (“1934 Act”) provides for comprehensive regulation of the trading of securities. One provision in particular has given rise to much of the litigation under the Act. Section 10(b) makes it 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 for the protection of investors . . .<sup>2</sup>

In 1942 the SEC promulgated Rule 10b-5, which makes it unlawful for any person

directly or indirectly, . . . , (a) To employ any device, scheme, or artifice to defraud, . . . or (c) To engage in act, practice or course of dealing which operates

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<sup>1</sup> 126 S.Ct. 1503 (2006).

<sup>2</sup> 15 U.S.C. § 78j(b) (2000).

or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>3</sup>

The Act does not provide for an express private remedy for injuries by violations of these provisions. However, *Kardon v. National Gypsum Co.*<sup>4</sup> held that there was an implied private remedy in the absence of any Congressional intent to deny a remedy. The Supreme Court implicitly recognized the existence of the private remedy twenty-five years later in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,<sup>5</sup> and explicitly endorsed the remedy twelve years after that in *Herman & MacLean v. Huddleston*.<sup>6</sup>

Having created a private action, the courts were left to define its boundaries. The logical starting place was the common law of fraud. But this body of law, developed largely in face-to-face transactions, proved unsuited to providing remedies for statements by firms to impersonal securities markets, which were the focus of the 1934 Act. Since Section 10(b) and Rule 10b-5 were part of that Act, courts faced the quandary of how far they should venture beyond the confines of the common law to accomplish the Act's purposes without usurping Congress' role.

Two cases have proved particularly important to the development of the 10(b) and 10b-5 private remedy. One fueled the expansion of the private cause of action into a powerful tool for plaintiffs' lawyers, while the other provided a judicial rationale for constraining that expansion.

One case concerns the reliance issue. An action for common law fraud requires proof that the plaintiff relied on the misstatement. This requirement impeded actions for fraud on public securities markets brought by purchasers or sellers who allege that they bought or sold during defendant's fraud. Federal Rule of Civil Procedure 23 bars a class action unless questions common to the class predominate over those concerning individual class members. This may not be the case if the plaintiff had to prove reliance as to each class member. Moreover, proof of reliance is arguably an unnecessary technicality in light of a version of the Efficient Capital Markets Hypothesis (ECMH) which holds that public disclosures are quickly reflected in market prices.<sup>7</sup> Under this theory, defendant's misrepresentation may affect securities prices, and therefore injure even traders who were completely unaware of the misrepresentation. The logistics of class actions and the ECMH provided the impetus and rationale for the "fraud on the market" theory adopted in *Basic, Inc. v. Levinson*.<sup>8</sup> There the Supreme Court held that a plaintiff could recover without proof of reliance based solely on proof that the plaintiff

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<sup>3</sup> 17 C.F.R. § 240.10b-5 (2000).

<sup>4</sup> 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>5</sup> 404 U.S. 6, 13 n.9 (1971).

<sup>6</sup> 459 U.S. 375 (1983).

<sup>7</sup> This was been referred to as the "semi-strong" version of the ECMH in an early article on the theory. See Eugene Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383 (1970).

<sup>8</sup> 485 U.S. 224 (1988).

traded after defendant made material public misrepresentations to an efficient market,<sup>9</sup> but before the truth was revealed.

The other important case is *Blue Chip Stamps v. Manor Drug Stores*,<sup>10</sup> which denied recovery by one who neither purchased nor sold stock – in this case, retailers who failed to exercise a right to buy stock given them under an antitrust decree allegedly because of misleadingly pessimistic statements in the prospectus that were intended to deter such purchases. The common law permitted recovery by non-purchaser/sellers under some circumstances.<sup>11</sup> But the Court was concerned about the danger of vexatious litigation that might arise in open-market cases if plaintiffs could sue even without the verification of injury provided by an actual purchase or sale. This concern for vexatious litigation has acquired increasing importance in the light of the class action litigation boom inspired by *Basic*.

Spiked by the fraud-on-the-market theory, the private class action remedy under 10(b) and 10b-5 grew into what some see as a major threat to firms trading in public securities markets. Congress heard evidence that firms were being sued whenever their shares dropped, that defendants were settling rather than paying the huge expense for discovery and trial, that "professional plaintiffs" who owned only a few shares were lending their names to complaints, and that litigation represented a "litigation tax" on business, particularly for smaller companies, that the risk of litigation was undermining firms' disclosure of information, and that the huge costs of the lawsuits ultimately were paid by long-term investors.<sup>12</sup>

Congress responded to these problems with the Private Securities Litigation Reform Act of 1995 ("PSLRA").<sup>13</sup> This Act included several provisions intended to curb abusive securities litigation, including higher pleading standards for federal securities fraud claims;<sup>14</sup> a stay of discovery while a court adjudicates a motion to dismiss;<sup>15</sup> a provision for selecting as lead plaintiff a shareholder with a significant stake in the action who presumably could monitor the lawyer for the class;<sup>16</sup> sanctions for frivolous

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<sup>9</sup> See Bradford Cornell & James Ruten, *Market Efficiency, Crashes and Securities Litigation*, available at <http://ssrn.com/abstract=871106> (surveying various tests of market efficiency under the fraud on a market theory).

<sup>10</sup> 421 U.S. 723 (1975).

<sup>11</sup> See Restatement (Second) Torts, § 525 (1976).

<sup>12</sup> See, e.g., S. Rep. No. 104-98, at 9-10 (1995).

<sup>13</sup> Pub. L. No. 104-67, 109 Stat. 737 (codified in part at 15 U.S.C. § § 77z-1, 78u-4).

<sup>14</sup> See 15 U.S.C. § 78u-4(b)(1), (2) (2000) (requiring that securities fraud complaints "specify" misleading statements and the facts on which plaintiff bases her belief is misleading, and "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"; *id* §78u-4(b)(4) (requiring allegation that the misconduct "caused the loss for which the plaintiff seeks to recover").

<sup>15</sup> *Id.* §§77z-1(b), 78u-4(b)(3) (2000).

<sup>16</sup> *Id.* §§77z-1(a)(3), 78u-4(a)(3) (2000).

litigation;<sup>17</sup> and a safe harbor for forward-looking statements, so issuers could disclose this information without fear of draconian liability.<sup>18</sup>

After the PSLRA was adopted, however, there was evidence that plaintiffs' lawyers were escaping the restrictions of the Act by taking the weaker claims that the PSLRA deterred into state court,<sup>19</sup> sparking a boom in state securities litigation.<sup>20</sup> As a result, Congress passed the Securities Litigation Uniform Standards Act ("SLUSA"), which explicitly prohibited a private party from maintaining under state law any "covered class action" 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.<sup>21</sup>

Congress thought it had closed the state law escape from the PSLRA. By using the same "in connection with" language as in §10(b) and Rule 10b-5, Congress seemed to be barring the actions under state law by which plaintiffs' lawyers had sought all of the benefits of the broad federal remedy without the PSLRA burdens.

But clever plaintiffs' lawyers were undaunted. Following SLUSA they started bringing actions under state law based on allegations that plaintiffs *held* securities. Although these cases technically involved misstatements or omissions "in connection with the purchase or sale of a covered security," the lawyers counted on the courts' holding that, because this language barred actions by holders of securities under *Blue Chip Stamps*, these actions were not preempted under the same language in SLUSA.

The Supreme Court disagreed. The Court unanimously held that SLUSA preempted actions by those who did not purchase or sell. It reasoned that *Blue Chip Stamps* relied on policy considerations specifically applicable to the private remedy context and was not intended as a definition of "in connection with the purchase or sale." When Congress enacted SLUSA, it was aware of and therefore presumptively used the broad judicial construction of the "in connection with" language.

The case seems straightforward, as indicated by the unanimous decision. As

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<sup>17</sup> *Id.* §§77z-1(c), 78u-4(c) (2000).

<sup>18</sup> *Id.* §§77z-2(c), 78u-5(c) (2000).

<sup>19</sup> *See, e.g.,* *Small v. Fritz Companies, Inc.* 30 Cal.4th 167, 65 P.3d 1255, 132 Cal.Rptr.2d 490 (2003) (holding that California law permitted action by non-seller and that SLUSA did not apply to such actions).

<sup>20</sup> *See* Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 *Stan. L. Rev.* 273, 17 (1998) (showing that "[t]he available data suggest that the most reasonable explanation for the increase in state court litigation is plaintiffs' desire to evade the Reform Act's procedural hurdles"). As it turned out, the concern may have been premature, since state actions declined even prior to passage of SLUSA. On the other hand, abusive state actions might have increased without SLUSA because of a post-SLUSA California decision clarifying the right to bring class actions on behalf of non-California plaintiffs. *See infra* note 44 and accompanying text.

<sup>21</sup> 15 U.S.C. §77p(b); *id.* §78bb(f)(1) (2000).

Judge Frank Easterbrook said in a case reaching the same result, “[i]t would be more than a little strange if the Supreme Court’s decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all.”<sup>22</sup> Nevertheless, as the Second Circuit noted in *Dabit*,<sup>23</sup> every federal appellate court that had considered the issue had refused to preempt holder actions as of the time of that decision.<sup>24</sup> Apparently only Judge Easterbrook thought the argument “strange.”

This article shows that the *Dabit* result is not as obvious as it might appear and that the case has significant policy ramifications for the future of federal and state roles in securities litigation, and for business regulation generally.

### III. CONSTRAINING ABUSIVE LITIGATION

The private right of action under 10(b) and 10b-5 started in *Kardon* as a seemingly logical way of furthering the Congressional purpose to increase disclosure and combat fraud. But throughout the history of private remedies neither the courts nor Congress have been able to deal adequately with the ants that keep arriving at the private rights picnic – the trial lawyers.

Plaintiffs’ lawyers theoretically can serve as important monitors of corporate disclosure. Most of the other potential monitors, including independent directors, government regulators, securities analysts employed by investment banking firms, and corporate executives, either lack strong economic incentives to monitor, or have incentives to hide information about their company or their clients. Insiders and their tippees face legal barriers to capitalizing on their information, while outside investors find it difficult to recoup their research costs because they lack strong property rights in information. By contrast, class action trial lawyers earn significant fees from successfully prosecuting securities fraud cases. Although these lawyers rarely uncover fraud, since they usually appear on the scene when at least some of the true facts have been discovered, they are experts at getting facts as to the wrongdoing of particular parties, and constructing legal theories that support liability.<sup>25</sup> In other words, while critics condemn class action lawyers’ fees, those fees provide the high-powered incentives other corporate monitors lack.

In practice, however, class action suits are not an ideal device for disciplining fraud. To begin with, there is what might be called the extortion problem – that a class

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<sup>22</sup> *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005), rev’d 126 S.Ct. 2145 (2006).

<sup>23</sup> *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 395 F.3d 25, 43-44 (2d Cir. 2005).

<sup>24</sup> See *Riley v. Merrill Lynch, Pierce, Fenner & Smith*, 292 F. 3d 1334 (11<sup>th</sup> Cir. 2002) (holding that SLUSA does not apply to claims dealing solely with the retention of securities); *Falkowski v. Imation Corp.*, 309 F.3d 1123 (9th Cir.2002) (holding that purchaser-seller rule satisfied by options transactions); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 598 (8th Cir.2002) (holding that “nonsellers and nonpurchasers of securities are not covered by SLUSA’s preemption provision”).

<sup>25</sup> See Bruce H. Kobayashi & Larry E. Ribstein, *Class Action Lawyers as Lawmakers*, 46 *Arizona L. Rev.* 733 (2004) (discussing role of class action lawyers in drafting pleadings).

action lawyer can squeeze a settlement out of the defendants even if the plaintiff has little likelihood of pressing the case to a successful conclusion.<sup>26</sup> If defendants cannot get the suit dismissed, or perhaps even while the dismissal motion is pending, they face burdensome discovery involving turning over thousands of documents and making busy executives available for hours of depositions. The company and its executives are potentially exposed to many millions of dollars of damages for losses to thousands of shareholders who traded before disclosure. Those who participated in the misrepresentations face personal liability and may not be entitled to indemnification or insurance against fraud. All of this makes managers highly susceptible to a “their money or your life” offer to settle in which they buy peace with the company’s (that is, current shareholders’) money. Thus, there was evidence prior to the PSLRA that a significant number of securities class action settlements were for nuisance value<sup>27</sup> and that settlement amounts did not depend on the merits of the claims.<sup>28</sup>

Even if the suit has significant *legal* merit it may involve damages in excess of the harm defendants caused. To understand this problem it is necessary first to quickly review how market damages are computed in securities fraud cases. Courts award each trading investor the difference between his trade price and the price at which the securities would have traded in the absence of fraud.<sup>29</sup> The non-fraud price is established by showing the market price of the security after disclosure of the true facts and then working back from that price to show how the company’s stock price would have fluctuated during the fraud period if there had been no fraud. These hypothetical price movements are based on how the general market moved and how the individual stock would have moved in relation to the market based on its risk compared to that of the market as a whole.<sup>30</sup>

There are several inherent problems with this damage theory. First, investors’ damages only very roughly measure the defendants’ distortion of their trade prices. It is obviously impossible to know what the stock’s price would have been at any time without defendant’s fraud. The court can determine only how the stock reacted to disclosure of *some facts*, which may differ from the same facts that defendants did not disclose. Yet the court has to construct an entire fictional history of stock prices based on this speculation about the undistorted price plus additional speculation about how the company’s stock price during the entire fraud period.

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<sup>26</sup> Even prior to the PSLRA, it is unlikely that plaintiffs were filing many suits that were completely worthless in the sense that they had no chance of success. See John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and its Implementation, Columbia Law and Economics Working Paper No. 293, at 3, n. 5 (2006), available at <http://ssrn.com/abstract=893833>. The problem, at least prior to the PSLRA, was that the cases had enough nuisance value that they were earning millions of dollars for plaintiffs’ lawyers even though everybody understood that the cases were either too weak or too small to justify the effort to take them to trial.

<sup>27</sup> See Joseph Grundfest, Why Disimply? 108 Harv. L. Rev. 727, 742-43 (1995) (twenty-three percent of settlements in sample were for less than \$2 million).

<sup>28</sup> See Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497 (1991).

<sup>29</sup> See *Green v. Occidental Petroleum Corp.*, 541 F. 2d 1335 (9<sup>th</sup> Cir. 1976).

<sup>30</sup> See Bradford Cornell & R. Gregory Morgan, Using Finance Theory to Measure Damages in Fraud on the Market Cases, 37 UCLA L. REV. 883 (1990).

Second, the alleged damages necessarily are far greater than the aggregate damage defendants actually caused to the market. The losses of those who bought too high or sold too low because of the fraud are exactly balanced by the gains of those who bought too low.<sup>31</sup> Moreover, damages are often inflated by investors' short-term overreaction to the corrective disclosure,<sup>32</sup> and by the market's reaction to the likelihood that the corporation itself will have to pay damages for the fraud.<sup>33</sup> Given these inherent problems with the basic damage calculation, even the much lower settlements,<sup>34</sup> further discounted by amounts institutional investors fail to claim,<sup>35</sup> may be significantly more than aggregate damage to the market.

Third, most shareholders who recover damages in securities fraud cases are already, in effect, "insured" against fraud. Reasonable shareholders buy and hold diversified portfolios of shares, usually through mutual funds, rather than trying to outguess the market.<sup>36</sup> This means that the vast majority of reasonable shareholders are as likely over time to be gaining from fraud as losing from it. In other words, not only are the damages significantly more than the aggregate damage to the market from defendant's fraud, as discussed above, but many of the individual plaintiffs arguably do not deserve compensation.

Even if the damages in securities class actions were appropriate, there is the additional problem that the wrong party bears the burden – that is, the corporation itself rather than the individuals who were actually responsible for the misrepresentations or nondisclosures.<sup>37</sup> Damage suits against the corporation reduce the value of the company's

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<sup>31</sup> See Frank Easterbrook & Daniel Fischel, Optimal Damages in Securities Cases, 52 U. Chi. L. Rev. 611, 638-39 (1985).

<sup>32</sup> See Larry E. Ribstein, Fraud on a Noisy Market, 10 Lewis & Clark L. Rev. 136 (2006).

<sup>33</sup> See Richard A. Booth, Who Should Recover What in a Securities Fraud Class Action? (Univ. of Md. Legal Studies Research Paper No. 2005-32 (2005), available at <http://ssrn.com/abstract=683197> But see Cornell & Morgan, *supra* note 30 (noting that this multiplier is limited by the fact that the market will discount for the probability that the recovery will be for only a small part of the alleged damages).

<sup>34</sup> See Coffee, *supra* note 26 at 14-15 (discussing studies showing that settlements over the last three years average less than three percent of investor market losses); Randall S. Thomas & James D. Cox, An Empirical Analysis of Institutional Investors' Impact as Lead Plaintiffs in Securities Fraud Class Actions, Vanderbilt Law and Economics Research Paper No. 06-09 (March 7, 2006), available at <http://ssrn.com/abstract=898640> (finding that ratio of settlement amounts to estimated provable losses was statistically significantly lower following the PSLRA).

<sup>35</sup> See James D. Cox and Randall S. Thomas, Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements, 58 Stan. L. Rev. 411 (2005) (finding that less than thirty percent of institutional investors with provable losses perfect their claims in securities class action settlements).

<sup>36</sup> See Booth, *supra* note 33.

<sup>37</sup> See Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 Stan. L. Rev. 1487, 1497 (1996). The executives may technically have personal liability for directly participating in the fraud, for which they are not entitled to indemnification. See *Globus v. Law Research Service*, 418 F.2d 1276 (2d. Cir. 1969) (barring indemnification under the federal securities laws for statements made with actual knowledge of fraud). However, this rule does not apply to settlements, and the insiders are usually

shares because of the prospect of monetary liability, defense costs and future insurance costs.<sup>38</sup> The shareholders therefore usually are victims rather than beneficiaries of the insiders' self-interested conduct.<sup>39</sup> Nevertheless, most reasonable shareholders who buy and hold diversified portfolios have no securities fraud claims of their own because they are not purchasers or sellers under *Blue Chip Stamps*. In short, securities fraud class actions involve significant wealth transfers from long-term investors to frequent traders and securities class action lawyers.<sup>40</sup>

Securities class actions involve not only perverse wealth transfers, but also potential social costs by deterring socially valuable activities. First, securities litigation may be especially burdensome for relatively innovative firms. These firms have more news to disclose, and their shares react more sharply to this news, than more seasoned companies. This litigation tax may deter the innovation and entrepreneurial activity that generate economic growth. Second, the risk of fraud liability may reduce the amount of information firms voluntarily disclose. This particularly affects forward-looking statements, which courts may evaluate in light of later information rather than the information the defendants had at the time of disclosure.<sup>41</sup> Investors would highly value management's assessment of the firm's prospects even if this involves some risk they may prove to be wrong. The litigation tax therefore may deter disclosures investors want.

The PSLRA fixed some of the problems with securities class actions, particularly by deterring weak lawsuits and suits based on forward-looking statements.<sup>42</sup> But the PSLRA did not address the inherent problem of assessing excessive damages against the victims of the fraud.<sup>43</sup>

Whatever the dangers of federal securities cases addressed by the PSLRA, the specter of state litigation addressed by SLUSA seems worse.<sup>44</sup> State actions expose firms

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able to arrange a settlement within the company's insurance limits that protects them from personal liability. See Coffee, *supra* note 26 at 33.

<sup>38</sup> These costs attributed to the suit are, of course, in addition to the fraud's effect on the firm's value. See *infra* note 48 and accompanying text.

<sup>39</sup> See *id.* at 28-29.

<sup>40</sup> See Alexander, *supra* note 37 at 1503 (noting that "payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up").

<sup>41</sup> See G. Mitu Gulati, Jeffrey Rachlinski and Donald Langevoort, Fraud by Hindsight, 98 Nw. L. Rev. 773 (2004) (showing that while courts have acknowledged this risk they have failed adequately to guard against it).

<sup>42</sup> See Adam C. Pritchard, Karen Nelson and Marilyn Johnson, Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act of 1995, J. L. Econ. & Org, available at <http://ssrn.com/abstract=883684> (forthcoming) (showing shift away from suits based on forward-looking statements greater correlation between the incidence of litigation and earnings restatements and abnormal insider selling, with a higher likelihood of settlement for cases involving earnings restatements).

<sup>43</sup> For problems with the PSLRA damage rules apart from who pays the damages, see Richard A. Booth, Windfall Awards under PSLRA, 59 Bus. Law. 1043 (2004).

<sup>44</sup> Note that the danger may have been less than Congress supposed when it enacted SLUSA.

to the risk of litigation, potentially including class actions,<sup>45</sup> in the courts of every state where they sell their securities. These actions are not constrained either by the PSLRA or by other restrictions on federal recovery, such as the purchaser-seller limitation.<sup>46</sup>

The above analysis strongly suggests that securities class actions involve costs in excess of their benefits. If that were all there was to the problem, securities fraud class actions could be comfortably abolished. However, as discussed in the next section, some fraud liability may be an efficient way to deter fraud and ensure that firms disclose an optimal amount of information.<sup>47</sup> Thus, the proper policy response may be to appropriately structure fraud liability rather than simply abolishing it. This response may demand the efforts of both federal and state lawmakers, rather than banishing state lawmakers from the scene as SLUSA does.

#### IV. CONTROLLING FRAUD

The above discussion focuses on the mitigating effect of investors' ability to "insure" against fraud by diversifying. But fraud nevertheless is obviously a negative event for both affected firms and the market as a whole. Fraud clearly may increase a firm's cost of capital. It casts doubt on the quality of the firm's management, thereby reducing expected returns. Fraud at least theoretically may cause the market to question the accuracy of other information the firm releases to the market, thereby increasing the firm's risk. Moreover, revelations of fraud in a company may infect other companies that the market suspects might have similar problems.<sup>48</sup> Indeed, the infection may spread to whole industries and the entire market by raising the general cost of capital, particularly for relatively new or innovative companies that will have the most difficulty reassuring investors, and causing general misallocation of resources.<sup>49</sup> It follows that private securities litigation, despite its defects, should not necessarily be abolished because it is a potentially effective way to deter securities fraud. Indeed, damages and settlements in securities cases dwarf the penalties imposed by other means.<sup>50</sup> In other words, the efficiency of private litigation can be assessed only in the context of all of the tools for fighting fraud.

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Although state court actions rose after the PSLRA, they began falling a year later, even before SLUSA was passed. *See* Richard W. Painter, *Responding To a False Alarm: Federal Preemption of State Securities Fraud Causes Of Action*, 84 *Corn. L. Rev.* 1, 42-46 (1998) (discussing data on state class actions).

<sup>45</sup> *See* *Diamond Multimedia Systems Inc. v. Superior Court*, 19 Cal.4th 1036, 968 P.2d 539, 80 Cal.Rptr.2d 828 (1999) (approving California class action on behalf of non-California buyers). *Diamond* came only after the adoption of SLUSA, within its exemption for pending actions. It is not clear whether trial lawyers would have won this victory in California had the stakes been higher.

<sup>46</sup> *See supra* notes 10-11 and accompanying text.

<sup>47</sup> *See* Easterbrook & Fischel, *supra* note 31.

<sup>48</sup> *See* Amar Gande & Craig M. Lewis, *Shareholder Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Spillovers*, (March 2006), available at <http://ssrn.com/abstract=891028> (finding evidence that the share prices of firms are affected by lawsuits against other firms in the same industry).

<sup>49</sup> *See* Coffee, *supra* note 26 at 32.

<sup>50</sup> *See id.* at 10-11.

Congress, however, has never done such a global assessment. Rather, Congress and the courts applying implied remedies have backed into a series of sometimes contradictory moves. The Court first implied broad civil remedies under 10(b) and 10b-5 without any explicit Congressional approval or detailed assessment of the costs and benefits of these remedies. Congress' first move was to enact the PSLRA and SLUSA during a stock market boom when fraud was not a major concern and litigation abuses were perceived to be the biggest problem facing securities markets. The revelation of Enron and other frauds in 2001 and 2002 convinced Congress to take some kind of action. Congress considered reversing the PSLRA limits on securities fraud cases, on the supposition that the reduced deterrent effect of securities fraud suits might have been responsible for the frauds.<sup>51</sup> But Congress chose instead to increase disclosure regulation and passed the Sarbanes-Oxley Act.<sup>52</sup> Meanwhile, the concern with litigation abuse remains, figuring not only in *Dabit*, but also in *Dura Pharmaceuticals, Inc. v. Broudo*,<sup>53</sup> which limited the fraud-on-the-market theory by tightening the loss causation requirement.<sup>54</sup>

This chain of actions has created a system in which huge penalties are assessed against the victims, large bounties are paid to trial lawyers, innocent firms face burdensome new regulation under the Sarbanes-Oxley Act,<sup>55</sup> and most fraudsters escape civil liability. The PSLRA not only did not fix the basic problem with burdensome securities class actions, but bolstered the argument for additional regulation when the market crashed. The only thing everybody seems to know about the scope and direction of securities regulation is that the federal government should remain in charge, as SLUSA made clear by blocking most state securities litigation. Yet federal law's lurching policy shifts argue against a single set of answers provided by a single federal regulator, and for preserving a role for the laboratory of state laws, as discussed in the next Part.

## V. BOLSTERING FEDERALISM

*Dabit* gave the Supreme Court a much needed opportunity to define state and

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<sup>51</sup> See Richard Painter, Megan Farrell & Scott Adkins, Private Securities Litigation Reform Act: A Post-Enron Analysis (2002), <http://www.fed-soc.org/pdf/PSLRAFINALII.PDF> (critically analyzing one pending bill). This study indicated that the supposition underlying the proposal was unfounded, as it showed that federal securities class action litigation had not actually declined in the wake of the PSLRA. For more recent data see Securities Litigation Watch, State of the (Securities Litigation) Union (July 5, 2006), [http://slw.issproxy.com/securities\\_litigation\\_blo/2006/07/state\\_of\\_the\\_se.html](http://slw.issproxy.com/securities_litigation_blo/2006/07/state_of_the_se.html) (summarizing data showing that securities class actions filings have fluctuated in a narrow range since the PSLRA, but that the average settlement size has significantly increased).

<sup>52</sup> See Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act, Pub. L. No. 107-204 (2002) (codified as amended in scattered sections of 15, 18 U.S.C. (2000)). Title VII of the Act is the Corporate and Criminal Fraud Accountability Act of 2002. § 801, 116 Stat., 800 (2002). Title IX is White Collar Crime Penalty Enhancements Act of 2002. § 901, 116 Stat., 804 (2002). Title XI is the Corporate Fraud and Accountability Act of 2002. § 1101, 116 Stat., 807-10 (2002).

<sup>53</sup> 125 S.Ct. 1627 (2005).

<sup>54</sup> See Ribstein, *supra* note 32 at 153-54 (discussing Court's reasoning in *Dura*).

<sup>55</sup> See Henry N. Butler & Larry E. Ribstein, *The Sarbanes-Oxley Debacle: What We Have Learned; How to Fix It* (AEI Press 2006) (discussing the significant costs, including the added risk of litigation of Sarbanes-Oxley).

federal roles in securities regulation. Courts implying a Section 10(b) remedy assumed that Congress thought a federal remedy was necessary to combat securities fraud despite the long history of the state common law fraud action and state securities, or “blue sky,” laws that the federal statutes had explicitly declined to preempt.<sup>56</sup> Moreover, implied remedies inevitably encroach on the law of internal corporate governance, which is predominantly a matter of state law.

In the last 40 years the Court has taken varying approaches to the relationship between federal and state law. *J.I. Case Co. v. Borak*<sup>57</sup> recognized a private remedy under the proxy provision of the 1934 Act based on the need for some enforcement mechanism, ignoring the fact that state corporate law had long dealt with shareholders’ role in corporate governance. In first applying the implied remedy in *Superintendent of Ins. v. Bankers Life & Cas. Co.*,<sup>58</sup> the Court seemed prepared to let federal law obliterate state law. The Court upheld the application of 10b-5 to an ordinary theft that was covered up through a securities transaction, reasoning that the “in connection with” language in 10(b) and 10b-5 reached any “deceptive practices touching” the sale of securities.<sup>59</sup>

The Court began to change course shortly after *Bankers Life*. The shift began in 1975 with the purchaser-seller standing rule in *Blue Chip Stamps*. Two years later, the Court held in *Santa Fe Indus., Inc. v. Green*<sup>60</sup> that Section 10(b)’s prohibition of “any manipulative or deceptive device or contrivance” “in connection with the purchase or sale of any security” did not reach a controlled merger that was no more than a state law breach of fiduciary duty without misrepresentation or nondisclosure. Two other cases decided around the same time, *Cort v. Ash*<sup>61</sup> and *Piper v. Chris-Craft Indus., Inc.*,<sup>62</sup> held that the existence of a private remedy depended at least in part on state law’s role in regulating the relevant area. In *CTS Corporation v. Dynamics Corporation of America*,<sup>63</sup> the Court declined to invalidate a state anti-takeover statute under either the Commerce Clause or the Supremacy Clause, reasoning that:

It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A State has an interest in promoting stable

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<sup>56</sup> See 1933 Act § 16, 48 Stat. 74, 84 (1933); 1934 Act § 28, 48 Stat. 881, 903 (1934).

<sup>57</sup> 377 U.S. 426 (1964).

<sup>58</sup> 404 U.S. 6 (1971).

<sup>59</sup> *Id.* at 12-13.

<sup>60</sup> 430 U.S. 462, 478-80 (1977).

<sup>61</sup> 422 U.S. 66, 78 (1975) (holding that one of four criteria for implying a remedy is whether the “cause of action [is] 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”).

<sup>62</sup> 430 U.S. 1 (1977) (holding, based on *Cort*, that plaintiff lacked standing under federal tender offer legislation, noting the existence of a state remedy for interference with prospective economic advantage).

<sup>63</sup> 481 US 69 (1987).

relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs.<sup>64</sup>

This concern for existing state law is also evident in preemption cases outside the corporate area. For example, in *Medtronic, Inc. v. Lohr*,<sup>65</sup> the Court, in an opinion by Justice Stevens, said that "[i]n all pre-emption cases . . . we 'start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.'"<sup>66</sup> In *Bates v. Dow AgroSciences LLC*,<sup>67</sup> the Court, again by Justice Stevens, said that, "because the States are independent sovereigns in our federal system, we have long presumed that Congress does not cavalierly pre-empt state-law causes of action."<sup>68</sup>

The Court, however, has not been consistent in its respect for state law. The Court's initial securities cases did not consider state law,<sup>69</sup> and paid scant attention to Congressional intent beyond assuming that Congress would want some enforcement mechanism. For example, *U.S. v. O'Hagan*<sup>70</sup> recognized a cause of action for misappropriation of information to trade, and *SEC v. Zandford*<sup>71</sup> allowed 10(b) recovery for simple theft of the proceeds of the securities sales, in both cases despite the long availability of remedies for theft and breach of fiduciary duty under state law.<sup>72</sup>

Rather than applying a general presumption against preemption of state law, the federal cases are better rationalized under a narrower principle of respecting state law relating to internal corporate governance. As discussed above, the Court explicitly singled that area out for protection both in the scope of the implied 10(b) remedy in *Santa Fe*, and in *CTS* regarding state and federal power to regulate takeovers.

This focus on internal governance can be explained on political grounds. As Jonathan Macey has argued, federal legislators normally hesitate to spend political capital to take over an area in which interest groups acting on the state level have made heavy

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<sup>64</sup> *Id.* at 91.

<sup>65</sup> 518 U.S. 470 (1996).

<sup>66</sup> *Id.* at 485 (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)).

<sup>67</sup> 544 U.S. 431 (2005).

<sup>68</sup> *Id.* at 1801.

<sup>69</sup> This disregard of state law runs through the Court's 10b-5 jurisprudence. See Mark J. Loewenstein, *The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law*, 39 *Ind. L. Rev.* 17 (2006).

<sup>70</sup> 521 U.S. 642 (1997)

<sup>71</sup> 535 U.S. 813 (2002).

<sup>72</sup> See Larry E. Ribstein, *Federalism and Insider Trading*, 6 *Sup. Ct. Econ. Rev.* 123 (1998) (discussing the links between the misappropriation theory and state law).

investments.<sup>73</sup> Conversely, where interest groups have only a minimal investment in state law, legislators may be willing to respond to interest groups that are seeking federal regulation. Applying this theory, where the case squarely deals with corporate governance the interest groups favoring state law, including lawyers, are too strong to make federal interference politically worthwhile. On the other hand, in securities fraud and other corporate cases which do not relate to internal corporate governance, federal securities law has become dominant and strong interest groups have invested in those laws.

This distinction between internal governance and other corporate cases also can be explained on policy grounds. The advantages of state competition are evident with regard to internal corporate governance.<sup>74</sup> This area of the law is heavily influenced by the state-of-incorporation choice of law rule, which promotes state competition by permitting firms easily to choose the law that applies to their corporate governance. Corporations have an incentive to choose the state law that minimizes their cost of capital given both the costs of regulation and litigation and the need to protect investors from mismanagement and fraud. In securities fraud and other corporate cases, by contrast, corporations cannot easily choose the applicable law, but are subject to suit wherever shares are sold or shareholders live. Here the dominant interest group is plaintiffs' lawyers, and they have little interest in anything other than expanding the scope of liability.

The special respect for state law dealing with internal corporate governance was evident in SLUSA. SLUSA not only limits troublesome state securities class actions, but also embraces the corporate-securities distinction by providing for an exception to the preemption of actions under state corporate law, often referred to as the "Delaware carve-out:"

(A) . . . . a covered class action described in subparagraph (B) of this paragraph that is based upon the statutory or common law of the State in which the issuer is incorporated ... may be maintained in a State or Federal court by a private party.  
(B) . . . . A covered class action is described in this clause if it involves-- (I) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or (II) any recommendation, position, or other communication with respect to the sale of securities of an issuer that--(aa) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and (bb) concerns decisions of such equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.<sup>75</sup>

The legislative history of this exception indicates that Congress was reluctant to invade the states' realm of regulating corporate governance and fiduciary duties of directors, and

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<sup>73</sup> See Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public Choice Explanation of Federalism*, 76 Va. L. Rev. 265 (1990). See also Jonathan R. Macey, *State and Federal Regulation of Takeovers: A View from the Demand Side*, 69 Wash. U. L. Q. 383 (1991).

<sup>74</sup> See Roberta Romano, *The Genius of American Corporate Law* (AEI Press 1993).

<sup>75</sup> 15 U.S.C. §77p(d)(1) (2000); 15 U.S.C. §78bb(f)(3)(a) (2000).

wanted to preserve the expertise and efficiency of Delaware courts and case law.<sup>76</sup> The exception was crafted to track existing Delaware law, including its distinction between statements made to the securities markets generally and those specifically relating to disclosures connected with shareholder action.<sup>77</sup>

It is important to emphasize that the corporate/securities distinction is not necessarily the optimal place to draw the line between the federal and state roles.<sup>78</sup> One problem is that the distinction impedes coherent resolution of closely related corporate disclosure and governance issues.<sup>79</sup> Congress broadly, and sometimes exclusively, regulates issues that are intimately related to corporate governance just by finding a securities law “hook.” For example, the federal government broadly regulates takeovers in the Williams Act.<sup>80</sup> It also regulates insider trading under 10(b) and 10b-5 even though the Supreme Court emphasized in *O’Hagan* that the basis of the regulation is theft, which is extensively regulated by state law.<sup>81</sup> Although federal regulation does not necessarily preempt state law, at least where application of that law is limited by the internal affairs doctrine as in *CTS*, there is a danger that the heavy hand of federal law will prevent full development of state law, as it has in the case of insider trading.

Just as federal securities law may invade state corporate governance regulation, so may state corporate law intersect with federal securities regulation. Disclosure is obviously relevant to shareholders’ ability to perform their traditional state law monitoring function, both in directly eliciting shareholder votes or transactions, and in enabling shareholders to decide when to pro-actively move to correct the managers’ governance failure. It therefore makes little sense to regulate disclosure and substantive governance powers under two separate bodies of law.

The problems with separating “corporate” and “securities” law are manifest in the Sarbanes-Oxley Act, which moves beyond the typical federal role of regulating disclosure to covering matters like those usually covered by state corporate law. These include provisions mandating complete independence of audit committee directors, including a new federal definition of director independence, controlling executive compensation by requiring executives to return bonuses to the company and by prohibiting certain executive loans, defining the power of a board committee by requiring that the board’s audit committee control the hiring and firing of accountants and the non-

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<sup>76</sup> See Jennifer O’Hare, Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Anti-Fraud Provisions of the Federal Securities Laws, 70 U. CINN. L. REV. 475, 501-04 (2002).

<sup>77</sup> *Id.* at 504. However, following the PSLRA, in a case to which the Act did not apply, Delaware expanded its disclosure duty beyond the statements the “carve-out” covers. See *infra* notes 110-111 and accompanying text.

<sup>78</sup> See Robert B. Ahdieh, From Federalization to Mixed Governance in Corporate Law: A Defense of Sarbanes-Oxley (Emory Public Law Research Paper No. 05-34, 2005), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=834386](http://papers.ssrn.com/paper.taf?abstract_id=834386).

<sup>79</sup> See Painter, *supra* note 44.

<sup>80</sup> Pub. L. 90-439, 82 Stat. 454 (1968).

<sup>81</sup> See Ribstein, *supra* note 72.

audit work accountants do for the corporation, and providing for SEC rules on off-balance-sheet transactions and special-purpose vehicles.<sup>82</sup>

Sarbanes-Oxley illustrates how federal law can encroach on the states in the absence of clear and easy to defend boundaries. A strong federal presence in corporate governance can discourage further development of state law, similar to the federal bankruptcy law's "vestigialization" of state-debtor creditor law that David Skeel has analyzed.<sup>83</sup> For example, despite the theft basis of insider trading law, federal law discourages the development of state law in this area.<sup>84</sup> When Congress decides, as in SLUSA, to preempt state law, the fact that state law is no longer entrenched or dominant then becomes relevant in interpreting the scope of preemption. Thus, while the degree of entrenchment of state law is arguably relevant to preemption on policy and political grounds, this factor can create a problem to the extent that it promotes creeping federalization of state law.

The current line separating federal and state law therefore has significant policy flaws. Part VII, below, suggests that there is a way to protect against both abusive litigation and fraud while preserving clear roles for federal and state law – that is, by making securities claims effectively part of the state's corporation law. However, Congress needs to be spurred into considering the appropriate roles of federal and state law. That is where the Supreme Court's holding in *Dabit* as to the preemptive effect of SLUSA enters the picture.

## VI. THE DABIT OPINION

The question in *Dabit* seems quite simple. The Court had to decide what state class actions Congress had meant to include as alleging "an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security." As Justice Stevens, who wrote the opinion, asked in the oral argument: "So, the question is whether we should construe the word "the" to be the functional equivalent of "his or her.""<sup>85</sup> And, of course, Congress referred to "*the* purchase or sale. . ." rather "his or her."

The issue in *Dabit* is complicated somewhat by the argument that the Court's decision in *Blue Chip Stamps* interpreted "in connection with" to include the purchaser-seller requirement, and that Congress implicitly accepted this interpretation when it used the same language in SLUSA. However, the Court easily dispensed with that argument, holding that

this Court in *Blue Chip Stamps* relied chiefly, and candidly, on "policy

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<sup>82</sup> See Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act, Pub. L. No. 107-204 (2002) (codified as amended in scattered sections of 15, 18 U.S.C. (2000), *supra* note 52).

<sup>83</sup> See David A. Skeel, Rethinking The Line Between Corporate Law and Corporate Bankruptcy, 72 Tex. L. Rev. 471 (1994).

<sup>84</sup> See *infra* note 116 and accompanying text (noting Delaware court's reluctance to challenge federal insider trading law).

<sup>85</sup> Transcript of Oral Argument at 6, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S.Ct. 1503 (no. 04-1371).

considerations” in adopting that limitation. [citation omitted] The *Blue Chip Stamps* Court purported to define the scope of a private right of action under Rule 10b-5-not to define the words “in connection with the purchase or sale.” [citation omitted]<sup>86</sup>

The Court also noted the broad interpretation of “in connection with” in cases like *Bankers Life, Zandford* and *O’Hagan*, noting that these interpretations had become “settled” in the meaning of the language.<sup>87</sup>

The Court acknowledged the presumption against preemption,<sup>88</sup> but held that it “carries less force here than in other contexts” because SLUSA merely denies the right to use the class action device rather than wholly pre-empting a state cause of action.<sup>89</sup> The Court also reasoned that the “tailored exceptions to SLUSA’s pre-emptive command demonstrate that Congress did not by any means act “cavalierly” here,”<sup>90</sup> and that “federal law, not state law, has long been the principal vehicle for asserting class-action securities fraud claims.”<sup>91</sup> The Court noted that, since state law holder actions were hardly ever asserted until after SLUSA, “[t]his is hardly a situation. . . in which a federal statute has eliminated a historically entrenched state-law remedy.”<sup>92</sup> Although *Blue Chip Stamps* indicated a concern with preserving state remedies, the Court said that “we are concerned instead with Congress’ intent in adopting a pre-emption provision, the evident purpose of which is to limit the availability of remedies under state law.”<sup>93</sup>

Not only did the Court view its interpretation as only modestly interfering with state law, but it also believed that it furthered the significant federal interest evident in SLUSA to control abusive litigation. The Court noted the “particular concerns that culminated in SLUSA’s enactment” to prevent state actions from frustrating the purpose of the PSLRA<sup>94</sup> and, echoing Judge Easterbrook’s language in *Kircher*, said “[i]t would be odd, to say the least, if SLUSA exempted that particularly troublesome subset of class actions from its pre-emptive sweep.”<sup>95</sup>

The oral argument indicates that the Court may was troubled by other elements of the case. Justice Breyer was concerned about whether clever plaintiffs could manipulate

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<sup>86</sup> 126 S. Ct. at 1512.

<sup>87</sup> *Id.* at 1513.

<sup>88</sup> *See supra* notes 65-67 and accompanying text.

<sup>89</sup> *Dabit*, 126 S.Ct. at 1514.

<sup>90</sup> *Id.*.

<sup>91</sup> *Id.*

<sup>92</sup> *Id.* at 1515.

<sup>93</sup> *Id.* at 1515, n. 13.

<sup>94</sup> *Id.* at 1513.

<sup>95</sup> *Id.* at 1514 (citing *Kircher*).

all purchaser-seller claims into holder claims, as the plaintiff had done in this case.<sup>96</sup> Chief Justice Roberts observed that “what [plaintiffs] want to do is cash in on the fraud. . . their claim is that they didn't get to sell the stock at an inflated price to somebody who didn't know about the fraud. That's the damages that they want to collect. And that seems to be an odd claim to recognize.”<sup>97</sup> And, indeed, disclosure of the truth would only have subjected the holders to the same harm as everybody else.

The *Dabit* result was, however, less straightforward than it might seem. To begin with, because the relevant statutory language was not clear, the presumption against preemption the Court applied in previous cases may not have been rebutted. The Court easily could have held that its purchaser-seller rule in *Blue Chip Stamps* was based at least partly on the “in connection with” language. The Court's suggestion that only the class action remedy rather than the plaintiff's right of action was being preempted<sup>98</sup> seems rather technical given the significance of the remedy to the enforcement of the right.<sup>99</sup> Although non-class actions might *allege* significant market damages, their actual value may be too low to attract much interest from plaintiffs or plaintiffs' lawyers.<sup>100</sup>

The Court's suggestion that the presumption against preemption should not apply because the state remedies were insufficiently “entrenched”<sup>101</sup> is also suspect. In fact, the state blue sky and fraud laws antedated the federal securities laws, and the 1933 and 1934 Acts explicitly preserve these remedies.<sup>102</sup> To be sure, the federal securities class action, particularly as developed after *Basic*, overshadowed state litigation, at least until adoption of the PSLRA. But there would not be much left of the presumption against preemption if it applied only where states make the same judgments as the federal government, such as to adopt rules conducive to nationwide securities class actions. Moreover, it is questionable whether the state remedy should be ousted as a result of *judicial* expansion of federal remedies without any political decision by Congress. Indeed, Congress' main role regarding the federal remedy has been to narrow it in the PSLRA.

The Court was arguably on firmer ground in stressing that the prior role of state law is less important where Congress expressly wants to preempt it than in a context like *Blue Chip Stamps* where the Congress has not expressed its intent. The preemption purpose here suggests that Congress wanted close questions to be decided for federal law. However, Congress was preempting only a particular type of state action – that is, a state action filed to circumvent federal restrictions in the PSLRA. Thus, the argument actually

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<sup>96</sup> Transcript of Oral Argument at 31-32, *Dabit*, 126 S.Ct. 1503 (No. 04-1371).

<sup>97</sup> *Id.* at 29.

<sup>98</sup> See *supra* note 89 and accompanying text.

<sup>99</sup> This holding in *Dabit* might be interpreted as indicating the Court's retreat from the class action remedy. The retreat is further supported by the Court's holding in *Dura* limiting the fraud on the market remedy.

<sup>100</sup> See *supra* notes 34-35 (noting that settlements and claims in securities class actions are much less than investor losses).

<sup>101</sup> See *supra* note 92 and accompanying text.

<sup>102</sup> See 15 U.S.C. §77p(a) (2000); 15 U.S.C. §78bb (a) (2000).

cuts the other way for *holder* actions that could not be brought in federal court even before the PSLRA. In other words, application to holder actions effectively extends SLUSA from an anti-circumvention statute to a broad restriction on all kinds of state actions. Although Congress evinced an intent to impose "*uniform*" standards, this still begs the question of the universe of actions that are to be treated uniformly. Thus, an ambiguity remains that arguably should be settled by the presumption against preemption.

To the extent that the Court's decision might have been driven by practical concerns with holder remedies, these problems are not as serious as they might seem at first glance. Justice Breyer's concern at oral argument that holder actions could swallow purchaser-seller actions is mitigated by the Second Circuit's insistence that the class include *only* those who were induced to hold, rather than to purchase or sell.<sup>103</sup> Nor were Judge Easterbrook and Justice Stevens necessarily correct in believing that holder claims are especially vexatious and therefore clearly the sort of action Congress sought to preempt in SLUSA. *Blue Chip Stamps* involved plaintiffs who had not bought the stock at all, in contrast to the plaintiffs in *Dabit*, who had clearly bought and then held. Although they are relying on a state of mind as to whether they would have sold if they had the true facts, the same might be said of typical fraud-on-the-market plaintiffs who are presumed to have relied merely from the fact have having bought into an efficient market after defendant's material misrepresentations. This reasoning could support a holding claim based on material misrepresentations and non-disclosures. Finally, although the vexatious nature of non-purchaser/seller claims applies to the *federal* remedy for trading losses, it does not necessarily apply to the sort of holder claims that the states might develop under the state-of-incorporation approach discussed below in Part VII.

Reduced to its essence, *Dabit* rests on the primacy of federal over state securities law. As Justice Stevens emphasized at the beginning of his opinion, "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated."<sup>104</sup> Thus, *Dabit* gives Congress a green light to regulate under the securities laws. This power may extend even to matters like those covered in Sarbanes-Oxley that arguably relate closely to internal corporate governance. There will accordingly be fewer areas in which state corporate law can be regarded as "entrenched" and therefore protected from preemption under the reasoning in *Dabit*. In short, *Dabit* gives momentum to the federalization of corporate law.

## VII. TOWARD A STATE ROLE IN SECURITIES REGULATION

Part VI suggests that there were strong arguments for deciding *Dabit* the other way – that is, refusing to preempt holder actions in the absence of explicit Congressional direction. A significant benefit of this result is that it would have forced Congress to decide what the state role should be in securities regulation. Even given *Dabit*, this issue is still potentially on the table. Moreover, the policy options available in the *Dabit* situation indicate the options that might be available in other contexts where preemption is at issue.

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<sup>103</sup> *Dabit*, 395 F. 2d at 47 ("[w]e therefore hold that when the class definition includes persons with SLUSA-preempted claims and does not permit the court to distinguish any non-preempted subclass, SLUSA requires that the claim be dismissed").

<sup>104</sup> *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1509 (2006).

This Part shows that there is a way to avoid both the risk of abusive state litigation and the danger of over-federalization while preserving a state role for disciplining fraud: Congress could amend SLUSA to, in effect, extend the “Delaware carve-out” to provide that federal law does not preempt disclosure regulation enacted as a part of a state’s business organization law and applicable to firms organized under that state’s law.<sup>105</sup>

Specifically, I propose exempting from preemption *any* “covered class action that is based upon the statutory or common law of the State in which the issuer is incorporated and brought in the courts of that State ... may be maintained in a State or Federal court by a private party.”<sup>106</sup> This tracks the current provision except that it deletes the qualification on exempted class actions in subsection (B) of the current version of the exception.<sup>107</sup> This rule would effectively ensure adoption of a state-of-incorporation choice-of-law rule for securities litigation – which otherwise might be opposed by trial lawyers and other interest groups – by federally preempting state law that is applied on any other basis.<sup>108</sup>

This broad exception for actions brought under state-of-incorporation law would address all three of the relevant considerations discussed in this paper – that is, abusive litigation, fraud and federalism. First, with respect to abusive litigation, the risk that states would become havens for costly corporate litigation is significantly mitigated if corporations can easily escape these states simply by reincorporating. The states would have incentives to consider litigation costs imposed on firms and their shareholders based out of state because they would lose incorporation business by adopting excessively burdensome laws. For the same reason, states also would have an incentive to clarify application of their laws and earn a reputation for legal stability. State legislators might be reluctant to support a corporate-type choice of law rule for state securities regulation over trial lawyers' opposition. My proposal would effectively impose such a rule by linking preemption with state-of-incorporation choice of law rule.

Second, while reducing abusive state litigation, my proposal would preserve a

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<sup>105</sup> O’Hare, *supra* note 76, proposes a similar rule. O’Hare’s suggestion is limited to liability based on the fiduciary duty of disclosure rather than, as I suggest, extended to any provision adopted as part of a state’s corporation law.

<sup>106</sup> The exemption would cover *any* action based on the law of the incorporating state of the issuer of shares that are the subject of the action. This would extend not only to the issuer and its agents, but also, for example, to parties like Merrill Lynch in the *Dabit* case which made recommendations concerning the issuer’s shares. Thus, firms would have to take into account in selecting their incorporating state whether that state’s law would unreasonably burden third parties like Merrill Lynch.

<sup>107</sup> *See supra* footnote 75 and accompanying text.

<sup>108</sup> The proposed rule also has the virtue of clarifying the application of the carve-out, since under the current version there are questions as to what sorts of statements it applies to. *See, e.g.*, *Greaves v. McAuley*, 264 F.Supp.2d 1078 (N.D. Ga. 2005) (holding that claims based on press releases and Form S-4 disclosures in connection with a merger are “to holders of equity securities of the issuer” and therefore are covered by the carve-out); *Alessi v. Baracha*, 244 F.Supp.2d 354 (D. Del. 2003) (holding that a recommendation to the shareholders deemed to concern “decisions of . . . equity holders with respect to . . . acting in response to a tender or exchange offer” even if it was in connection with a buyout program that was not technically a tender or exchange offer). These ambiguities are exacerbated by the Supreme Court’s holding that decisions to remand to state court are not reviewable even if they are contrary to SLUSA. *See Kircher v. Putnam Funds Trust*, 126 S.Ct. 2145 (2006).

viable state role in regulating fraud. To be sure, some may be concerned that the restriction to state-of-incorporation laws would spur a competition for laxity in fraud rules. Just as states may externalize costs of excessively burdensome securities laws onto out-of-state firms and their managers in order to attract litigation, so might they externalize costs of excessively lax corporate laws onto out-of-state investors in order to attract corporate managers, who instigate firms' incorporation decisions. However, corporations and their managers have incentives to “bond” their disclosures by incorporating in states that offer reasonable protection against fraud. Firms choosing lax states risk increasing their costs of attracting capital from investors. For this reason, firms based in countries with lax securities regulation and enforcement have voluntarily listed their securities in the U.S. and other countries with stronger laws.<sup>109</sup> Thus, state-of-incorporation fraud laws can provide an efficient backup to federal antifraud law.

Third, with respect to the federalism consideration, my proposal would preserve a state role in disclosure regulation. This is significant because letting the federal government monopolize securities litigation removes any chance the states might have to experiment with different liability regimes. An example of the role the states might play in regulating securities disclosure and fraud is provided by *Malone v. Brincat*,<sup>110</sup> in which the Delaware supreme court let shareholders sue directors for breach of fiduciary duty based on false financial statements in SEC reports and shareholder communications.<sup>111</sup> Since the plaintiffs were holders rather than trading shareholders, the theory of recovery potentially supplements federal liability. However, the court's theory was also narrower than federal law in that the court did not apply the fraud-on-the-market presumption of reliance, imposed a higher scienter requirement than under federal law, applied the business judgment rule to director judgments about disclosure, and allowed for the possibility of a duty of care opt out. *Malone* upheld the lower court's dismissal on the basis that plaintiff had not alleged exactly how the fraud had injured the shareholders, but allowed the plaintiff to plead a specific damage theory, without suggesting what that theory might be. The Delaware courts and other states might have explored several alternatives in subsequent cases. They also might choose to relax one or more of these limitations, or impose other restrictions on recovery. But SLUSA effectively prevented state courts from developing the *Malone* theory of recovery. The proposed expanded carve-out would rectify this problem.

The claims the proposed carve-out authorizes would be in addition to potential corporate derivative actions that SLUSA already permits because they are not “covered class actions.”<sup>112</sup> Shareholders might be able to show that the defendants' fraud damaged the corporation by, for example, reducing the credibility of its management and future

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<sup>109</sup> See Larry E. Ribstein, Cross-Listing and Regulatory Competition, 1 Review of Law & Economics, no. 1, Article 7, available at <http://www.bepress.com/rle/vol1/iss1/art7> (2005) (discussing evidence of the bonding theory of cross-listing).

<sup>110</sup> 722 A.2d 5 (Del. 1998). Like *Diamond*, the case arose after passage of SLUSA but before its effective date.

<sup>111</sup> This action would be preempted under SLUSA as interpreted in *Dabit* because it alleged fraud other than in connection with issuer communications regarding specific shareholder votes or other actions.

<sup>112</sup> A “covered class action” is defined as a lawsuit in which “damages are sought on behalf of more than 50 persons or prospective class members.” Securities Act of 1933, §16(f), 15 U.S.C. §77p(f)(2)(A) (2000), Securities Exchange Act of 1934, §28(f), 15 U.S.C. §78bb(f)(2)(A), (5)(B) (2000). By contrast, a derivative action is sought on behalf of a single party, the corporation.

disclosures, and thereby reducing expected returns and increasing risk.<sup>113</sup> These types of state law claims would have important advantages over the fraud-on-the-market claim that is the focus of federal law and market-based actions under state law because they would seek recovery against wrongdoing insiders on behalf of, rather than against, the corporation. Moreover, the liability's deterrent effect would depend more on the structure of the settlement – that is, whether it requires personal contributions from wrongdoing insiders – than on the total amount of the damages.<sup>114</sup>

It is unclear that Delaware would, in fact, have developed the *Malone* theory, in particular by articulating the basis for measuring damages, even if SLUSA let it do so. Chief Justice Steele of the Delaware Supreme Court was quite skeptical of the plaintiff's theory when he was Vice Chancellor, noting that

When a shareholder is damaged merely as a result of the release of inaccurate information into the marketplace, unconnected with any Delaware corporate governance issue, that shareholder must seek a remedy under federal law. . . . Congress has articulated a standard of disclosure to protect the national securities market. It makes little sense for Delaware courts to impose either a duplicative or stricter standard on directors of Delaware corporations. Neither the Delaware corporation code nor the common law suggests that Delaware can or should pick up the perceived regulatory slack when federal scrutiny may not include review of every actionable theory divivable by a dogged plaintiff.<sup>115</sup>

Vice Chancellor Strine was similarly dubious about plaintiff's argument for state law insider trading liability, noting that “[i]t might . . . fuel further legislative developments, as what was understood by Congress to be a narrow and fixed "Delaware carve-out" for traditional fiduciary duty claims turns out to be an expanding excavation site that unsettles the structure of federal securities law.”<sup>116</sup>

While Delaware courts now may resist expanding securities fraud remedies, this does not indicate that permitting a state corporation law remedy would be empty or futile. First, other states, particularly including California, might take a different approach. Indeed, the California supreme court showed none of Vice Chancellor Strine's reticence about colliding with federal law when it permitted securities class actions by out-of-state buyers even after SLUSA.<sup>117</sup> Second, even Delaware might be bolder if federal law clearly authorized state-of-corporation regulation, rather than the more qualified signal

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<sup>113</sup> See *supra* note 49 and accompanying text.

<sup>114</sup> In this respect these state actions would reach the result suggested by Professor Coffee of restructuring settlements in federal fraud-on-the-market cases to ensure a greater contribution by the wrongdoers. See Coffee, *supra* note 26. At the same time, these actions, unlike Coffee's solution, would preclude recovery of excessive fraud-on-the-market damages, with all of the problems these suits entail, as discussed above in Part II.

<sup>115</sup> *Malone v. Brincat*, No. 15510, 1997 WL 697940 (Del.Ch., October 30, 1997), rev'd, 722 A.2d 5 (Del. 1998).

<sup>116</sup> *In re Oracle Corporation Derivative Litigation*, No. Civ. A18751, 2004 WL 2756278 at 24 (Del.Ch. December 2, 2004) (footnotes omitted).

<sup>117</sup> See *supra* note 45 and accompanying text.

Congress gave in SLUSA.<sup>118</sup> Third, it is not clear what any states, including Delaware, might do if Congress or the U.S. Supreme Court were to significantly shrink the federal remedy. To be sure, the states generally have shown little appetite to regulate substantive disclosure requirements since the advent of the federal securities laws. But this could reflect transactional lawyers' preference for a single federal law. On the other hand, it would not be surprising to see litigators press for state fraud law, though under a state-of-incorporation approach they would have to contend with corporate lawyers who want to their states to continue to attract incorporations.

Finally, even if states do not authorize a significant remedy, this does not mean that they are acting inefficiently. The states' decision not to act once the choice-of-law rule forces them to internalize the costs as well as the benefits of litigation may instead mean that no state remedy is justified. In other words, the state "laboratory" may be providing useful guidance as to the appropriate scope of securities fraud liability.

To be sure, my proposal is not a perfect solution. Unlike Roberta Romano's proposal that federal law should permit firms to choose the jurisdiction that provides its securities laws,<sup>119</sup> my suggestion does not let firms opt out of federal law or select a securities law jurisdiction that is different from the state of incorporation.<sup>120</sup> However, while Romano's proposal is probably the right endpoint for securities law, it is not realistic to expect a spontaneous realignment of the political interests that support the current equilibrium. My proposal would facilitate an incremental approach through which full-fledged jurisdictional competition could evolve. One possible scenario would be for Congress and the federal courts to use the survival of a viable state remedy as a justification for shrinking the federal remedy. The Supreme Court in *Dura*<sup>121</sup> notably appeared headed in this direction, but stopped short of clarifying the precise contours of the fraud-on-the-market remedy.<sup>122</sup> The Court or Congress might be emboldened to confront the manifest problems of the federal remedy if SLUSA left a clear state fallback rather than the existing statute's more limited exception to preemption.<sup>123</sup>

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<sup>118</sup> Delaware's reluctance to push the envelope of state liability given the PSLRA and SLUSA is consistent with Mark Roe's theory about the constraints federal law imposes on state competition. See Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588 (2003).

<sup>119</sup> See Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L. J. 2359 (1998).

<sup>120</sup> However, as with state actions after the PSLRA and holder suits after SLUSA, plaintiffs would probably use the state remedies only for cases not covered by the federal remedy. It is conceivable that plaintiffs would choose to sue in state court in order to try to take advantage of the ability to obtain a global settlement there under *Matsushita Electric Industrial Co. v. Epstein*, 516 U.S. 367 (1996). For an analysis of the relevant issues, see Painter, *supra* note 44 at 95-99.

<sup>121</sup> See *supra* notes 53-54.

<sup>122</sup> See Ribstein, *supra* note 54, 154-65 (discussing the potential implications of *Dura*).

<sup>123</sup> This sort of evolution toward a choice-of-law regime also could result from firms' cross-listing their securities in foreign markets, as cross-listing jurisdictions provide exemptions from their laws first to foreign firms, and then to domestic firms. See Ribstein, *supra* note 109.

## VIII. CONCLUSION

This article has shown that the basic problem facing the Court and Congress in securities regulation is how to address the tripartite concerns of abusive litigation, the need to constrain fraud, and the need to preserve a role for state corporate law. The problem is that these considerations seem mutually exclusive. Federal law therefore has been buffeted in multiple directions, first toward broad judicial remedies, then toward restricting federal remedies in the PSLRA and state remedies in SLUSA, then broadening federal regulation in the Sarbanes-Oxley Act.

*Dabit* presented an opportunity to encourage Congress to consider another alternative – the laboratory of state law. Although the Court treated the issue as straightforward, in fact it was far from clear that SLUSA preempted holder suits. If the Court had held that state holder suits were allowed under SLUSA in the absence of explicit preemption, Congress would have been forced to consider whether to allow supplemental state securities regulation. This article suggests an alternative path Congress could have taken in the wake of such a holding – that is, expand SLUSA’s Delaware carve-out to allow the states to get back into the securities business through their corporate statutes. This could lead to a much better reconciliation of the three objectives mentioned above.

Although *Dabit* went the other way, this article’s analysis is still relevant in showing what may be lost by excessive willingness to expand federal power, at least in the corporate and securities area. There are unexplored state options that could provide a path to a more rational and coherent approach to regulation. The Court should consider what might be gained by forcing Congress to reconsider the states’ role through more rigorous application of a presumption against preemption.

Whatever the Court were to decide in *Dabit*, the relative roles of federal and state corporate and securities regulation raise important questions for both Congress and the courts. We could hardly do worse than the current situation.