The Preemptive Reach of SLUSA and Mutual Fund Investors

Atkinson v. Morgan Asset Management, Inc.

The Securities Litigation Uniform Standards Act ("SLUSA") makes federal court the exclusive jurisdiction for certain class actions that allege fraud under state law in connection with the purchase or sale of securities. SLUSA is designed to prevent plaintiffs from circumventing the strict requirements of the PSLRA by filing their claims in state rather than federal court. The scope of SLUSA is continually tested in litigation. Recently, the Sixth Circuit in Atkinson v. Morgan Asset Management, Inc., No. 09-6265, 2011 WL 3926376 (6th Cir. Sept. 8, 2011), held that SLUSA preempts state-law claims for securities fraud with respect to redeemable mutual fund shares. The decision will have a significant impact on securities fraud claims brought in state court by holders of mutual fund shares.

The plaintiffs in Atkinson, held redeemable mutual fund shares, which entitled holders to redemption at any time for their proportionate share of the issuer’s current net assets. After the shares lost value, the plaintiffs filed a state-court class action, alleging that the fund and its affiliates took unjustified risks in allocating the funds’ assets and then concealed those risks from the shareholders. Had the plaintiffs been aware of those risks, they continued, they would have redeemed their shares before they dropped in value. The defendants removed the case to federal court under SLUSA. See 15 U.S.C. § 77p(b), (c), (f)(2)(A), (f)(3). The plaintiffs asked the district court to remand the case back to state court. The district court refused and the plaintiffs appealed to the Sixth Circuit.

On appeal, the plaintiffs made two arguments. First, they argued that SLUSA did not apply based on an exemption in the statute called the “Delaware carve-out.” Under this exemption, a class action that is otherwise preempted by SLUSA may
remain in state court so long as the class action involves 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. 15 U.S.C. § 77p(d)(1)(B). This carve out generally applies to cases involving tender offers, mergers, or share buybacks when directed exclusively to existing shareholders. In this case, the plaintiffs argued that as because they held mutual funds that were redeemable at any time, the fund had an ongoing contract to buy these securities from the investors. Therefore, the plaintiffs concluded, the class action involved the purchase of securities by the issuer.

The Sixth Circuit disagreed. First, the court said that the fund’s redemption obligation does not make the fund a “purchaser” under the carve out. Second, the court noted that the plaintiffs’ claim was inconsistent with Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006), where the Supreme Court held that SLUSA preempts state-law “holder” claims. A holder claim alleges injury based on the prolonged retention of stock as a result of fraud and this is prohibited under the securities laws, which demand that the plaintiff be either a purchaser or seller of securities. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). According to the Sixth Circuit, to interpret holders of redeemable mutual funds as continuous buyers or sellers would “pull the rug out from under Dabit’s holding, creating an exemption for a large set of the very holder claims over which Dabit extended SLUSA’s bar.”

Second, the plaintiffs argued that several of their claims were not covered by SLUSA because fraud was not an element of the state-law claims. But the Sixth Circuit disagreed with this argument as well and held that for SLUSA purposes, preemption was appropriate so long as the plaintiffs’ claims included allegations of misrepresentations in connection with the buying and selling of securities.

The Sixth Circuit’s decision is available here: