

Recent Supreme Court Decision Preserves Investors' Access to State Courts

When financial misconduct harms shareholders, the federal securities laws are a powerful source of protection. But they are not the only source, and state laws might also protect against the same misconduct. Indeed, a shareholder sometimes may be better served by framing the lawsuit as a state case rather than a federal one, and by filing in state court. And states themselves presumably want their courts to be open to litigants seeking to enforce state laws.

But what if, as part of that framing, the shareholder wants to mention that the defendant's conduct also breached a duty created under the federal securities laws, not because the shareholder wants to sue for that breach *per se*, but simply to provide detail? The federal securities laws give federal courts jurisdiction over cases "brought to enforce" those laws. See Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa(a) (Exchange Act) (conferring exclusive jurisdiction of suits "brought to enforce" the Exchange Act); Section 21 of the Securities Act of 1933, 15 U.S.C. § 77v(a) (Securities Act) (conferring concurrent jurisdiction suits "brought to enforce" for Securities Act claims). Does that permit, or even require in the case of the Exchange Act, the shareholder's state-court case be transferred to federal court, depriving the shareholder of her choice of forum, and the state of the opportunity to have its own court to hear the case?

In the recently decided *Merrill Lynch Pierce Fenner & Smith Inc. v. Manning*, No. 14-1132 (May 16, 2016) (*Manning*), the Supreme Court said no. If the case brings only state law claims, the fact that it also mentions federal duties doesn't mean it is "brought to enforce" federal law. And except in the rarest of circumstances, the case should stay in state court.

Background

In *Manning*, the plaintiffs were shareholders in Escala Group Inc. They alleged that the defendants, which were financial institutions, drove down the value of their shares by participating in "naked" short-selling of Escala stock, *i.e.* selling shares they didn't own, hadn't borrowed, and crucially, never intended to actually deliver to counterparties. Such practices may be subject to Regulation SHO, a regulation promulgated by the U.S. Securities and Exchange Commission that imposes certain requirements on broker-dealers in connection with naked short sales.

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The Escala shareholders, however, didn't sue for violation of Regulation SHO, or any other federal law or regulation. Instead, they asserted only causes of action under New Jersey statutes and common law, including the New Jersey Racketeer Influenced and Corrupt Organizations ACT (RICO), the New Jersey Uniform Securities Law, and the New Jersey common law of negligence, unjust enrichment, and interference with contractual relations.

However, the complaint also repeatedly stated that the conduct violated Regulation SHO. This, defendants claimed, meant the lawsuit belonged in federal court.

The District and Circuit Courts' Decisions

The Escala shareholders filed their case in New Jersey state court, and defendants promptly removed to the United States District Court for the District of New Jersey. The defendants argued the federal court had jurisdiction under both 28 U.S.C. § 1331, which provides federal courts with jurisdiction over cases that "arise under" federal law, as well as exclusive federal jurisdiction under § 27 of the Exchange Act, which provides federal courts with exclusive jurisdiction over cases "brought to enforce any duty or liability created by [the Exchange Act]."

The Escala shareholders argued the case should be remanded to state court, because they asserted only state law claims, and the mere mention of Regulation SHO wasn't enough to turn theirs into a federal case.

The district court sided with defendants, holding that it had jurisdiction under § 27 as well as federal question jurisdiction under 28 U.S.C. § 1331. On interlocutory appeal, however, the U.S. Court of Appeals for the Third Circuit reversed. 772 F.3d 158 (3d Cir. 2014).

As to § 1331, the Third Circuit applied the test set forth by the Supreme Court in *Grable & Sons Metal Products Inc. v. Darue Engineering & Manufacturing*, 545 U.S. 308 (2005) for determining whether federal courts have § 1331 jurisdiction over cases involving only state-law claims. That test provides that federal courts have jurisdiction over state-law claims if the case involves "a federal issue that is: (1) necessarily raised, (2) actually disputed, (3) substantial, and (4) capable of resolution in federal court without disrupting the federal-state balance approved by Congress." 545 U.S. at 312.

Third Circuit found no such jurisdiction existed because the federal issue of whether defendants actually violated Regulation SHO was not "necessarily" raised by the Escala shareholders' complaint. After all, the shareholders could prevail on all their claims even if the court never decided whether Regulation SHO

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was violated. As for § 27, the Third Circuit concluded that it presented essentially the same question as § 1331. The only difference was, if jurisdiction existed under § 1331, the case *could* be heard in federal court, whereas if it existed under § 27, the case *had* to be heard in federal court. And, given that jurisdiction didn't exist under § 1331, it could not exist under § 27 either.

Defendants appealed, and the Supreme Court granted certiorari.

The Supreme Court's Decision

In a unanimous decision, the Supreme Court agreed with the Third Circuit. It held that, despite the different language used by § 1331 (“arising under federal law”) and § 27 (“brought to enforce any liability or duty created by [the Exchange Act]”), the jurisdiction they conferred was co-extensive, and that the test set forth in *Grable* applied. And because the Escala shareholders' claims did not “necessarily raise” the federal issue of whether defendants actually violated Regulation SHO, there was no federal jurisdiction.

The Court did recognize that, as with § 1331 “arising under” jurisdiction, § 27 would grant federal jurisdiction over state claims if the state law said something like: it is a violation of state law to violate the Exchange Act. But those, the Court noted, are “rare occasions.”

The court thus affirmed the Third Circuit's decision, with the result that the case will be remanded back to New Jersey court, where it began, and where the Escala shareholders finally will be able to press their claims under New Jersey law.

Analysis and Conclusion

Manning is a win for plaintiffs and shareholders. Defendants in securities cases generally prefer federal courts because they are perceived as more defendant-friendly, with the stringent standards imposed *Twombly/Iqbal* and the Private Securities Litigation Reform Act. *Manning* hampers the ability of defendants to force cases into federal court. Plaintiffs and shareholders, meanwhile, prefer to have the option of proceeding in state court. *Manning* preserves that option. Along those lines, *Manning* is also a win for states themselves. It rejects the notion that states should be prevented from regulating securities violations as they see fit, and shows respect for state courts and state laws generally.

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