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When Does the Securities Litigation Uniform Standards Act of 1998 Preempt State Law Claims?

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SECURITIES LITIGATION

When Does the Securities Litigation Uniform Standards Act of 1998 Preempt State Law Claims?

by Steven A. Ramirez

In 1995, Congress enacted (over presidential veto) the Private Securities Litigation Reform Act (PSLRA), which restricted investor remedies under the federal securities laws. Thereafter, investors sought to redress wrongdoing by corporate insiders under state law. Congress responded by enacting the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which further restricted investor rights against corporate management by preempting rights investors had under state law. Specifically, under SLUSA, any class action alleging a misrepresentation of a material fact "in connection with" the purchase or sale of a security issued by a publicly held company must be brought in federal court under the more restrictive PSLRA.

Shadi Dabit brings claims arising from the very well-publicized misconduct of Merrill Lynch in recommending securities, under the guise of its research analyses, when in fact its recommendations were aimed at currying the favor of corporations in order to garner investment banking business. Dabit's claims were brought under state law for breach of fiduciary duty and breach of the contract duty of good faith and fair dealing, and he sought to pursue these claims as a class action.

He claims he was fraudulently induced to hold securities, as opposed to being induced to buy or sell them. The circuit courts are split on the question of whether Dabit's claims remain viable. The Seventh Circuit would dismiss such claims as preempted by federal law. The Second Circuit would permit such claims to the extent they revolve around the holding of securities as opposed to the purchase or sale of securities. Holding claims have long been found not viable under federal law.

(Continued on Page 216)
Does the Securities Litigation Uniform Standards Act of 1998 preempt state law claims brought as class actions for fraudulently inducing holders of securities of public companies to continue to hold their securities (as opposed to purchase securities) because such holding is "in connection with the purchase or sale" of securities, even though federal law recognizes no remedy for such a holding claim?

**Facts**

Dabit is a former broker with Merrill Lynch. In 2002, he filed this action on behalf of himself and other former and current Merrill Lynch brokers, alleging that Merrill Lynch distorted its research reports to attract investment banking business by overrating stocks. Dabit's claim was based upon the investigation undertaken by New York Attorney General Elliot Spitzer. Spitzer's 2002 investigation found that Merrill Lynch research analysts gave stocks glowing recommendations, while privately terming such stocks "crap" or a "dog." Merrill Lynch has publicly apologized for its misconduct, has paid substantial fines and judgments, and has faced numerous law enforcement and regulatory inquiries and sanctions.

Dabit seeks recovery for two kinds of losses. First, he claims losses for himself and other members of the class for damages for holding securities based upon Merrill Lynch's deceptive research analyses. Second, he claims losses suffered by the class from the loss of clients who closed their accounts in the wake of revelations of Merrill Lynch's misconduct. The putative class was defined as Merrill Lynch brokers who suffered losses from holding stocks based upon the flawed Merrill Lynch research reports or those who lost clients because of Merrill Lynch's misconduct. The class time period is from December 1, 1999, to December 31, 2000.

Dabit pursued recovery under state law for breach of fiduciary duty and breach of the contractual duty of good faith and fair dealing in the federal district court for Oklahoma under diversity of citizenship jurisdiction. The district court ruled that SLUSA preempts claims based upon the purchase or sale of securities and dismissed the complaint with leave to file an amended complaint for "claims based on wrongfully induced holding." Dabit's amended complaint was transferred to the Southern District of New York, by the Judicial Panel on Multidistrict Litigation, where it was administered with 120 other actions against Merrill Lynch related to its biased research reports. Following transfer, Dabit's amended complaint was dismissed with prejudice. The court found that Dabit's claims were all "in connection with the purchase or sale of a nationally traded security" within the meaning of SLUSA, even though Dabit's claims were carefully crafted to remove any reference to the purchase of securities and instead referenced only the wrongfully induced holding of securities. The court's conclusion was based upon the finding that Dabit's claims "were based on the very same alleged transactions and occurrences" involved in the federal litigation surrounding the Merrill Lynch research reports. The court therefore concluded that the holding claims were squarely within the ambit of SLUSA and dismissed. Dabit appealed to the Second Circuit Court of Appeals.

The Second Circuit reversed in part and affirmed in part. Recognizing that in crafting SLUSA Congress borrowed the "in connection with" language from Section 10(b) of the Securities Exchange Act of 1934, the Second Circuit construed the identical language from SLUSA in light of the U.S. Supreme Court's construction of that language from Section 10(b) in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). There, the Supreme Court found that the "in connection with the purchase or sale" of securities language meant that only purchasers and sellers had standing to bring claims under Section 10(b). Therefore, the Second Circuit held that only claims relying upon a wrongfully induced purchase are within the scope of SLUSA's preemption. Because the Dabit complaint did not negate the possibility of that—it included claims of wrongfully induced purchases—the Second Circuit affirmed the dismissal of the complaint; but, it permitted the plaintiff to amend his complaint to clarify that the claims at issue allege no misrepresentation in connection with any purchase. Rather, the plaintiff must show the misrepresentations at issue only induced the plaintiff to retain the securities.

Merrill Lynch sought review from the U.S. Supreme Court and on September 27, 2005, its petition for a writ of certiorari was granted.

**Case Analysis**

This case has its roots in the PSLRA, which was enacted as part of Newt Gingrich's Contract with America. The PSLRA imposed heightened pleading requirements upon plaintiffs in federal securities litigation, restricted the availability of class actions, imposed something close to a "loser pays" fee-shifting regime, and created a safe harbor for forward-looking frauds, among other things. The PSLRA became law over President Clinton's veto and has remained controversial through the present day. Indeed,
many commentators assign some degree of blame to the PSLRA for the flood of corporate wrongdoing that came to light beginning in late 2001 with revelations of widespread fraud at Enron Corporation. Others claim that restricting the ability of investors to recover for corporate wrongdoing has been beneficial in limiting strike suits.

Whatever its merits or demerits, after the PSLRA became law plaintiffs shifted claims out of federal court and pursued state-based remedies in state court to avoid the strictures of the PSLRA. In 1998, Congress responded with SLUSA. Essentially, SLUSA requires that any class action involving allegations of misrepresentation “in connection with the purchase or sale” of a nationally traded security be brought in federal court under the PSLRA. 15 U.S.C. § 78bb(f)(1).

The “in connection with” language has a long history in securities law. In Blue Chip Stamps the Court relied on the same language from Section 10(b), which authorizes antifraud measures, including private claims for securities fraud, to find that only purchasers or sellers of securities—not mere holders of securities—may assert claims for securities fraud. More recently, in SEC v. Zandford, 535 U.S. 813 (2002), the Court held that any misrepresentations “coinciding” with the purchase or sale of securities meets the “in connection with” requirement.

Judge Easterbrook, in Kircher v. Putnam Funds Trust, 403 F.3d 478 (7th Cir. 2005), found that this language from Zandford supports the conclusion that the “in connection with” language means only that the fraud at issue concerns securities transactions, rather than some other kind of activity. He further found that “it would be more than a little strange” if the Court’s decision in Blue Chip Stamps, which imposed a standing requirement on private plaintiffs to be either a purchaser or a seller in order to bar “potentially vexatious” holding claims, could now be used to save holding claims from the preemptive sweep of SLUSA.

On the other hand, a number of courts, in addition to the Second Circuit, have found that Blue Chip Stamps does indeed countenance this result. The Court in Blue Chip Stamps stated that “the wording of § 10(b), making fraud in connection with the purchase or sale of a security a violation of the Act, is surely badly strained when construed to” encompass claims by nonpurchasers and nonsellers. The Eighth Circuit and the Eleventh Circuit have thus held that Blue Chip Stamps operates to save holding claims from the preemptive sweep of SLUSA. Riley v. Merrill Lynch, 292 F.3d 494 (11th Cir. 2002); Green v. Ameritrade, Inc., 279 F.3d 590 (8th Cir. 2002).

Against this backdrop, the petitioner’s arguments rely upon a broad reading of SLUSA. The following is an excerpt of their argument:

“Congress set forth SLUSA’s preemptive scope and effect in extremely broad language: ‘No covered class action which is based upon the statutory or common law of any State’ may be maintained in ‘any State or Federal court’ by any private party who ‘allege[s]’ either a misrepresentation of a material fact or a deceptive device or contrivance ‘in connection with the purchase or sale of a covered security.’ ...”

“The operative language of SLUSA’s preemption provision that is relevant to this case, ‘in connection with the purchase or sale’ of a ... security, tracks the language contained in the 1934 Act, which this Court has broadly interpreted as not limiting coverage to deception of an identifiable purchaser or seller. ...”

“The court of appeals held that putative plaintiffs may avoid the preemptive scope of SLUSA and proceed with their state law class actions if they allege that they held, rather than purchased or sold, securities as a result of the alleged misrepresentations. In so deciding, the court imported into SLUSA’s preemption provision an extratextual purchaser-seller limitation. Yet, the purchaser-seller rule upon which the court relied was created by this Court on policy grounds as a standing limitation on the judicially created private damages remedy. ...”

“The court of appeals’ interpretation of the scope of SLUSA’s preemption provision as limited by the ‘purchaser-seller’ standing rule is therefore inconsistent with the plain language and natural meaning of the broad statutory text. In addition, the court of appeals’ decision frustrates the legislative scheme enacted in SLUSA, by which Congress sought to further a uniform national legal regime with respect to nationally traded securities by disallowing private class actions from proceeding under disparate state substantive and procedural standards.”

The import of Merrill Lynch’s argument would be that the plaintiff be deprived of any state law claims and relegated to pursue relief under federal law. However, federal law recognizes no claim for holders, as opposed to purchasers or sellers, of securities. Thus, plaintiffs would be left to no claim at all for any misconduct committed in connection with holding securities.

The respondent’s argument relies on a more limited conception of preemption.
"A private plaintiff alleging that a defendant's bad acts caused a decrease in the value of an investment has not 'alleged' wrongdoing 'in connection with the purchase or sale of a covered security' under SLUSA, unless the plaintiff also alleges that the defendant's misstatements or omissions were made in connection with the plaintiff's purchase or sale. That interpretation of SLUSA flows from the text of the statute, accords with this Court's presumption against preemption, fulfills Congress's purpose in enacting SLUSA, and is necessary to ensure the integrity of the Nation's securities markets. ...

"First, in private securities litigation under ... the phrase 'in connection with the purchase or sale' has a settled judicial interpretation: A private party does not assert a claim 'in connection with the purchase or sale of any security' within the meaning of section 10(b) ... unless that party avers that the defendant's act or omission was in connection with her own purchase or sale." SLUSA applies solely to private suits for damages and should be interpreted in accordance with this Court's cases construing section 10(b). ...

"Second, this Court presumes that Congress does not intend to preempt traditional state-law causes of action. The States have regulated the securities industry for more than 150 years, and investors have brought state-law holder claims for more than a century. Petitioner and its amici exaggerate the need for uniformity in the securities industry, which provides no warrant for disregarding the traditional presumption against preemption. ...

"Third, Congress's purpose, as evidenced by the legislative history, was to preempt only those claims that could have been brought under federal law. Congress enacted SLUSA to prevent plaintiffs from evading heightened federal pleading requirements by filing such claims in state court under the guise of state law. Congress intended to secure a cause of action to all legitimately aggrieved investors, preserving state-law class actions where state law presented the only available remedy. ...

"Fourth, state-law class actions are necessary to deter fraud in the securities industry. The limitations of public securities enforcement have repeatedly been recognized by Congress, this Court, and the SEC itself. Petitioner's proposed construction of SLUSA would functionally eliminate any right of action, in any courtroom at any level, for millions of defrauded investors. By denying investors the opportunity to pursue legitimate but low-value claims through class actions, petitioner's preferred interpretation would ensure that the many American households with modest long-term savings will never be compensated adequately for their losses. Such a construction of SLUSA is contrary to the long tradition of private securities enforcement and unnecessary as a practical matter. State legislatures and state courts are more than capable of establishing workable standards to manage non-purchaser and non-seller claims and to prevent frivolous suits."

Accordingly, the respondent seeks to uphold the Second Circuit's holding.

The Securities and Exchange Commission submitted one of many amicus briefs. Its argument is that class actions and liberal discovery rules "create a substantial risk of abusive and counterproductive 'strike' suits." The SEC also is concerned that the scope of its enforcement authority is at stake. The broader the phrase "in connection with" is found to be, then the broader is the SEC's enforcement authority under Section 10(b). This militates in favor of the SEC arguing for a broad interpretation of "in connection with," even though that means a broader preemptive sweep under SLUSA and therefore less private litigation to supplement the SEC's resources. Thus, the SEC posits that Blue Chip Stamps was a standing case, and not a construction of "in connection with." The SEC further argues that there is need for uniformity that would be compromised if plaintiffs could bring claims for being wrongfully induced to hold securities. Finally, the SEC argues that the Second Circuit's decision "would have the perverse effect of reading a law designed to eliminate abusive and meritless lawsuits to preserve the suits most likely to be abusive and meritless."

SIGNIFICANCE

In recent decades, the Court has been hostile to private litigation under the federal securities laws. It seems to think such litigation is "vexatious" and economically harmful because it operates to enrich class counsel at the expense of corporations. Since the real parties in interest are current shareholders who rarely commit fraud, commentators have generally not been charitable toward private securities litigation. Thus, the Court, following this lead, has repeatedly cut back the viability of private securities litigation.

The respondent's brief seeks to make much of recent scandals that have arguably sprouted up in the backwater of the Court's reluctance to enforce the securities laws vigorously in the context of private litigation. Thus, the respondent seems to be hoping that recent corporate scandals will temper the Court's evi-
enced bias against strong private enforcement of the securities laws.

Certainly, the Court is well aware of the harm to investor confidence that occurred in the wake of the historic run of fraud that was revealed beginning in 2001, and continuing to the present day. This harm to investor confidence will necessarily raise the cost of capital to American business. Nevertheless, the Court may well leave that job to Congress and continue its efforts to restrict private securities litigation.

In terms of the specific claims at stake in this case, there were many holders of securities of many public companies that may have committed fraud. If SLUSA has not abolished these claims, under the guise of SLUSA's preemption of class litigation, then one may expect to see many more class-action holding claims under the laws of various states.

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Phillip Goldstein and Bulldog Investors (Robert L. King (314) 621-4012)
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Burdens/standards of proof — As a general matter, the party in a lawsuit asserting a claim or defense has the burden of presenting evidence that establishes the claim or defense. This is known as the burden of proof.

There are three burdens of proof. From the least to the most demanding, they are the preponderance-of-the-evidence burden of proof, the clear-and-convincing burden of proof, and the beyond-a-reasonable-doubt burden of proof.

The first two burdens can apply in either criminal or civil cases, while the third applies only in criminal cases and then only to the prosecution.

There are no ready definitions for these burdens. There are, however, working definitions. Under the preponderance standard, the party with the burden of proof is required to come forward with credible evidence establishing that a claim or defense is more likely true than not. Under the clear-and-convincing standard, the party with the burden of proof is expected to present evidence establishing that the claim or defense is quite likely true. Under the beyond-a-reasonable-doubt standard, the prosecution must present such evidence of the defendant's guilt that a reasonable person would not hesitate to find the defendant guilty. See *Victor v. Nebraska*, 114 S. Ct. 1239 (1994).

Class action lawsuit — As a general rule, a class action lawsuit is one in which one or several named individuals sue for themselves and others believed to have sustained injuries or losses similar to those sustained by the named plaintiffs, but who, at the time the case is filed, are unknown both as to their identities and their actual numbers. In order for a plaintiff's lawsuit to be given class action status, the named plaintiff must show that (1) the class is so large as to make it impracticable to specify each and every plaintiff by name, (2) there exist questions of law or fact common to all members of the plaintiff class, (3) the claims of the named plaintiffs are representative of the claims of the unnamed plaintiffs, and (4) the named plaintiffs can fairly and adequately represent the interests of the entire plaintiff class. (Note: Less common is the class action lawsuit in which the class is composed of named and unnamed defendants or in which both the plaintiffs and the defendant's side of the case constitute a class.)

Collateral review (see also habeas corpus) — Collateral review is the criminal law's fail-safe mechanism. It is intended to ensure that a conviction and sentence satisfy the requirements imposed by law, constitutional and statutory. As its name suggests, collateral review looks at a convicted defendant's trial and in some cases the sentencing proceeding; it is not, however, a second trial. As a general rule, collateral review is limited to issues of law.

To be eligible for collateral review, the petitioning party must be in custody at the time the process begins. Typically but not necessarily, custody means imprisonment. For those convicted of state-law crimes, collateral review is available under state law and federal law, the latter in the form of a petition for a writ of habeas corpus. As a general rule, state-law petitioners must exhaust all avenues of collateral review available under state law before filing a federal habeas corpus petition. For federal-law petitioners, federal habeas corpus review is available after certain post-conviction avenues such as a motion to vacate a conviction or sentence have been exhausted.

For both state-law and federal-law petitioners, federal habeas corpus review begins in a trial-level court but, in the collateral-review context, the trial court functions as a reviewing court. However, if the federal habeas corpus petitioner is unsuccessful in habeas court, he or she is permitted, within limiting procedural rules, to seek further review of the habeas court's decision in the appropriate intermediate federal appeals court and, if unsuccessful there, in the Supreme Court.

Damages — In law, damages means money given to a party whose legal interests have been injured. While there are several types of damages that can be given to an injured party, two of the most prominent types are compensatory damages and punitive damages.

An award of compensatory damages is a sum of money intended to make the injured party whole. Insofar as this is possible.

An award of punitive damages is intended to punish the wrongdoer in order to deter future wrongdoing. Usual, punitive damages go to the injured party and are over and above any award of compensatory damages. However, in some states, a portion of any punitive damages award goes to the state treasury.

Direct review — In American criminal law, a defendant is tried once, but the trial itself can be reviewed many times by many appellate courts. One channel of review is called direct review because it is initiated by a first appeal as a matter of statutory right. Direct review also is wide-ranging review because the convicted defendant is permitted to raise all procedurally proper issues regarding the trial court's disposition of his or her case — including issues of law, issues of fact, and issues concerning the trial judge's use of discretion.

If the first appeal is resolved against the convicted defendant, appellate rules permit the defendant to seek discretionary review by still higher courts, generally by the highest court of the convicting state and then by the United States Supreme Court. (In federal criminal cases, the convicted defendant's initial appeal as a matter of right is to a circuit court of appeals and then as a matter of discretion to the Supreme Court.) If these courts
decline to hear the defendant’s case or hear the case but decide against the defendant, or if the defendant defaults on his or her right to seek discretionary review, the direct review process ends and it is said that the defendant’s conviction and sentence are final. At this point, the only avenue of relief from a conviction or sentence — retrial, resentencing, or outright release — is collateral review, defined above.

Discovery — Discovery is a pretrial device in which each party to a lawsuit seeks information from the other party as well as from non-parties believed to have knowledge relevant to the issues in the case. The plaintiff seeks information through discovery to make his or her case; the defendant seeks information to support any defenses that may be available.

Diversity — This term is used whenever a federal court has jurisdiction over a case that does not involve a question of federal law. While there are several types of diversity jurisdiction, the most common type has two requirements: (1) the plaintiff and the defendant are residents of different states; (2) the dollar amount of the dispute between the parties is at least $75,900, exclusive of interest and costs.

En banc — The term literally means “full bench.” Cases in the federal circuit courts of appeals are typically heard and decided by panels of three judges who are drawn from all the judges in that circuit. In rare instances, the court may subsequently agree to have the case reargued, this time in front of more or all of the judges from that circuit.

Habeas corpus — Under the federal habeas corpus statute, 28 U.S.C. §2254 (1994), a person held in state/local custody who believes that his or her custody violates federal law — typically, the Constitution — may challenge that custody by filing a petition for a writ (i.e., an order) of habeas corpus in federal district court. If the petitioner wins, he or she must be released or retried, at the option of the prosecuting authority.

Per curiam opinion — This term literally means “the opinion of the court,” the Supreme Court or any appellate court. Because the opinion is the court’s opinion, there is no indication of which justice/judge wrote it.

Plurality opinion — This term denotes an opinion of the United States Supreme Court in which there is no majority opinion; that is, fewer than a bare majority of five justices were able to agree on the legal basis for the Court’s action in affirming, reversing, or vacating a lower court decision. In some cases, the Court’s opinion can be a partial plurality opinion. A partial plurality opinion is one in which at least one part of the opinion represents the views of four or fewer Justices. For an example of a partial plurality opinion, see Hubbard v. United States, 115 S. Ct. 1754 (1995) (Parts IV and V, a plurality of three Justices; Parts I, II, III, and VI, a majority of six Justices).

Preemption — Under the Supremacy Clause, U.S. Const. art. VI, §2, federal law — whether based on the Constitution, a statute, or a treaty — takes precedence over state or local law on the same matter. In other words, if federal law addresses a matter, either expressly or by implication, it trumps and renders unenforceable any state or local law on the matter.

Qualified immunity — Qualified immunity is a defense that can be raised by a government employee whenever there is uncertainty about the lawfulness or unlawfulness of certain actions taken by the employee, actions claimed by the plaintiff to be unlawful. A government employee can avoid a trial under this defense if the employee can show that, at the time of the complained-of action, he or she could not have known that it violated the law.

Strict scrutiny — Strict scrutiny is a searching level of judicial review applied to governmental actions — federal, state, and local — challenged as unconstitutional. Strict scrutiny requires the governmental actor to show that it had a compelling reason to take the challenged action and that the action taken goes no further than necessary — is narrowly tailored — to advance the cited compelling reason.

Summary judgment — This is the name of a procedural device available to either party to a civil lawsuit that enables one or the other party to win without a trial. A party seeking summary judgment is entitled to a judgment in its favor if there is no genuine dispute about the pertinent facts, and, based on those undisputed facts, the law compels a judgment for the party who has asked for a favorable ruling.
COVERING THE COURT’S ENTIRE FEBRUARY CALENDAR OF CASES, INCLUDING ...

LEAGUE OF UNITED LATIN AMERICAN CITIZENS ET AL. V. PERRY ET AL.

In 2003, the Republican-controlled Texas legislature redrew the lines for its 32 congressional districts. The redistricting plan replaced a court-drawn plan that was enacted following the 2000 census and after the legislature was unable to draw its own plan. Various plaintiffs challenged the plan on the grounds that it violated the one-person, one-vote requirement, constituted an impermissible political gerrymander, and diluted the votes of voters of color in violation of the Voting Rights Act and that mid-decade redistricting violates the First and Fourteenth Amendments.

MARSHALL V. MARSHALL

In this case, the Court is asked to determine the vitality of the so-called probate exception to federal court jurisdiction that generally limits, if not prohibits, federal courts from hearing litigation relating to the probate of a decedent’s estate. The Court’s consideration of the continuing validity of the probate exception follows a similar reconsideration of the domestic relations exception in Ankenbrandt v. Richards, a 1992 case in which the Supreme Court upheld the domestic relations exception to federal court jurisdiction.

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### Monday

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**February 21**

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- S. D. Warren Company v. Maine Board of Environmental Protection et al.

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- Randall et al. v. Sorrell et al.

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- Samson v. California
- Holmes v. South Carolina

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- DaimlerChrysler Corp et al. v. Cuno et al. and Wilkins et al. v. Cuno et al.
- Northern Insurance Company of New York v. Chatham County, Georgia
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<td>Dwight L. Smith</td>
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<td>Juanita C. Hernandez</td>
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<td>Mary T. Torres</td>
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<td>W. Scott Welch</td>
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<td>Jackson, MS</td>
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### Advisory Commission on Public Education

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<th>Diane Minnich</th>
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<td>Boise, ID</td>
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<td>Sweet Briar, VA</td>
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<td>Mary McFarland</td>
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<td>Peter Suzuki</td>
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