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Alito Denies Stay in NJ RICO Case Over 'Naked' Short Sales

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A multimillion dollar racketeering case over alleged illegal "naked" short sales of stock is about to start moving forward in New Jersey state court almost three years after it was filed.

On March 9, U.S. Supreme Court Justice Samuel Alito denied a request to stay a decision by the U.S. Court of Appeals for the Third Circuit, which had remanded the suit back to Morris County Superior Court based on a lack of federal subject matter jurisdiction.

The defendants, which include Merrill Lynch Pierce Fenner & Smith, Knight Capital Americas, UBS Securities and E*Trade Capital Markets, had applied for a stay pending decision on a petition for certiorari they plan to file.

The plaintiffs in *Manning v. Merrill Lynch* are shareholders in the Escala Group, a New York-based international network of companies specializing in collectibles such as stamps, according to court documents.

One of them, Greg Manning, of Boonton, New Jersey, claimed he owned 2.1 million shares at the relevant time, with lesser amounts held by the other plaintiffs, a Swedish individual and companies in Sweden, Norway, Denmark and Luxemburg, according to court documents.

Plaintiffs allege in court documents that the defendants engaged in a massive manipulation of the market for the company's common stock over a four-day period in May 2006 and again from Dec. 1, 2006 through Jan. 9, 2007, trading a combined 182 million Escala shares.

"Defendants substantially injured plaintiffs while at the same time reaping enormous profits by knowingly and intentionally creating, loaning and selling unauthorized fictitious and counterfeit shares of Escala stock, through various unlawful schemes and devices and by engaging in the unlawful practice of naked short sales," the complaint says.

Short sales are sales of securities that the seller does not own but has borrowed in the expectation that when the short seller later acquires the stock for delivery to the buyer, the price will have fallen, with the short seller profiting from the drop.

In naked short sales, which are not inherently illegal, the seller has not borrowed the stock or assured that it will be available later to deliver to the buyer within a required timeframe.

Merrill Lynch and the other defendants conducted short sales of Escala stock without having reasonable grounds to believe the securities could be borrowed and become available for delivery, the complaint alleges.

The complaint claims the defendants increased the pool of tradable Escala shares by "electronically manufacturing fictitious and unauthorized phantom shares" and using non-registered shares to dilute the fixed percentage owned by the plaintiffs to cause their shares to decline in value. They then allegedly sold or loaned the fictitious shares, "reaping significant monies in unlawful profits and fees" and covered up the scheme.

The 10-count complaint, filed in state court in May 2012, alleged violation of the New Jersey Racketeer Influenced and Corrupt Organizations Act statute based on predicate acts of New Jersey securities fraud and theft and state common law claims, including breach of contract, unjust enrichment and interference with economic advantage.

The defendants removed it to federal court in Newark in July 2012, asserting federal question jurisdiction on the grounds that the crux of the action was the violation of the federal regulatory scheme regarding short sales.

In particular, they relied on Regulation SHO, adopted by the Securities & Exchange Commission in 2005 to address problems with failure to deliver, including "potentially abusive 'naked' short selling." New Jersey has no analogous provision.

In December 2012, U.S. Magistrate Judge Michael Hammer of the District of New Jersey agreed with the plaintiffs that the case should be remanded because it consisted of state law claims that could be decided "without addressing the embedded federal issues."

U.S. District Judge Jose Linares of the District of New Jersey, however, rejected Hammer's recommendation and denied a remand in March 2013.

The Third Circuit granted an interlocutory appeal and reversed on Nov. 10, 2014, finding that the issue of whether naked short selling violates New Jersey law need not be answered by reference to Regulation SHO.

"Because the success of plaintiffs' state-law causes of action does not 'necessarily' depend upon the contents of federal law, this case does not 'arise under' the laws of the United States," wrote Third Circuit Judge D. Brooks Smith, joined by Judges Thomas Vanaskie and Dolores Sloviter. "The presence of an exclusive jurisdiction provision governing Regulation SHO does not change the analysis, as such provisions cannot independently generate jurisdiction."

On Jan. 15, the Third Circuit denied rehearing en banc and refused a stay pending decision on the defendants anticipated petition for certiorari.

Subsequently, the case was sent back to the district court, which on Feb. 19 transmitted it to Morris County.

On Feb. 24, the stay application was submitted to Alito, who handles such filings within the third circuit. The defendants argued that their planned certiorari petition raised important issues, noting that Section 27 of the Exchange Act grants federal courts exclusive jurisdiction of actions to enforce duties created by federal securities laws.

They pointed out that the circuits had split on whether the section provides an independent basis for jurisdiction, with the Second and Third Circuits saying it did not while the Fifth and Ninth held that it did. Allowing the litigation to go forward in New Jersey state court would cause irreparable harm to them and every other participant in the national securities market if the New Jersey court rules before the U.S. Supreme Court resolves the conflict on jurisdiction, the defendants contended.

"The result would be inconsistent enforcement of securities regulations, as state courts begin to interpret issues that are supposed to be exclusively federal under Section 27," the defendants argued in court papers, adding that would be "a regulatory nightmare."

In addition, the defendants said they would be denied their rights to a federal forum and the federal law's prohibition on discovery in securities cases until heightened pleading standards have been met. Alito denied the application without explanation.

John Schepisi and Gregory Dexter of Schepisi & McLaughlin in Englewood Cliffs, New Jersey, who along with Neal Flaster of Florham Park, New Jersey, represent Manning, said they expect the defendants will move to dismiss in state court.

The case involves practices that are common in the industry, and the defendants are "so desperate to defend this proceeding because it will change the way they function," Schepisi said.

The plaintiffs prefer to be in state court because they expect a quicker resolution there than in federal court, he said.

The plaintiffs are claiming damages of about \$50 million, which could be trebled under RICO. Merrill Lynch lawyer Andrew Frackman of O'Melveny & Myers referred a request for comment to Bank of America Merrill Lynch in-house counsel Brendan Dowd, who in turn referred the request to the company press office, which declined to comment.

Rebecca Brazzano of Thompson Hine in New York, representing National Financial Services, and Andrew Clubok of Kirkland & Ellis in Washington, D.C., representing UBS, also declined to comment.

Other defense counsel did not return calls seeking comment.

The defendants have argued in motion papers that plaintiffs are to blame for the stock drop, referring to a police raid on Escala's offices in Spain during an investigation into a pyramid scheme and SEC charges against Manning that ended with an order requiring him to pay nearly \$670,000 in fines and barring him from serving as an officer or director of a public company for 10 years.

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