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SOUTHERN DISTRICT CIVIL PRACTICE ROUNDUP

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Class Action Litigation Reform Update

In the past decade, Congress has enacted two statutes designed to steer certain types of class action litigation from state to federal court. The Securities Litigation Uniform Standards Act of 1998 (SLUSA)[1] prevents plaintiffs from pursuing covered securities fraud class actions in state court by completely precluding the application of state law to such claims and by providing that they be litigated exclusively in federal court under federal law.

The Class Action Fairness Act of 2005 (CAFA),[2] while not applicable to securities fraud and corporate governance class actions, facilitates pursuit of many other class actions in federal court by expanding federal jurisdiction in two significant respects: it permits the exercise of jurisdiction based on minimal diversity and allows the aggregation of class members' damages in order to satisfy a $5 million amount in controversy requirement.

Several recent decisions from the U.S. District Court for the Southern District of New York and the U.S. Court of Appeals for the Second Circuit explore the limits of the expanded jurisdictional territory charted by these statutes.

SLUSA

SLUSA was enacted to prevent class action securities plaintiffs from filing claims in state court under state law in order to make an end-run around the restrictions imposed by the Private Securities Litigation Reform Act of 1995 (PSLRA).[3] SLUSA contains a preclusion provision which provides that actions based on state law, brought on behalf of more than 50 persons, alleging either misrepresentation or omission of a material fact or the use of a manipulative device in connection with the purchase or sale of a security, may not be maintained by any private party in any state or federal court.[4] It also contains a provision authorizing removal to federal court of any action covered by the preclusion provision.[5]

Just as plaintiffs sought to avoid the strictures of the PSLRA by resorting to the state courts, they have sought to avoid SLUSA by styling their complaints so as to assert state law claims that fall outside of the preclusion provision. But because SLUSA reflects Congress's clear intention to pre-empt state law, courts are empowered to look beyond the "well-pleaded complaint rule" to determine whether the

plaintiff has engaged in "artful" pleading to avoid pre-emption.[6] Competing efforts to jockey for control of the applicable law and forum have engendered a certain degree of pleading gymnastics and resultant litigation.

Last year, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*,[7] the U.S. Supreme Court rejected the argument that SLUSA was inapplicable to claims by plaintiffs who had held securities as a result of some fraud. The Court concluded that the distinction between holders on the one hand, and purchasers and sellers on the other, was irrelevant, reversing a decision by the Second Circuit which had found that claims by a "holder-class" were exempt from SLUSA preemption. With this avenue closed, plaintiffs have sought other approaches to keep their complaints in state court.

A. Federal Claims in State Law Clothing? The plaintiffs in *Paru v. Mutual of America Life Ins. Co.*[8] successfully argued that their breach of fiduciary duty claim had been improperly removed under SLUSA. The complaint in that case alleged that defendant had breached its fiduciary duty to holders of variable annuity contracts by permitting other investors to engage in market timing (a form of short-term trading) to the detriment of the class. In support of their motion to remand, plaintiffs asserted that their complaint for breach of fiduciary duty did not allege any untrue statement or material omission and was thus not pre-empted by SLUSA.

Southern District Judge John E. Sprizzo accepted that characterization, rejecting the defendant's argument that the complaint contained "implicit" allegations of misstatements triggering SLUSA. Specifically, he found that defendant's representation of itself as an expert in long-term investments implied no promise to protect investors from market timing. He was similarly unpersuaded by the defendant's efforts to characterize plaintiffs' claim as a failure to disclose the market timing, finding instead that the complaint was based on the defendant's failure to prevent that conduct. Finally, he rejected the argument that the pricing of the fund was inaccurate and thus misstated, concluding instead that the pricing was accurate but inherently inefficient.

By contrast, the court looked beyond the breach-of-contract claim alleged in *Felton v. Morgan Stanley Dean Witter & Co.*,[9] finding that plaintiffs' claims were in fact securities fraud claims. The plaintiffs, who held investment accounts at Morgan Stanley, alleged that the research provided by Morgan Stanley analysts to assist customers in investment decisions was tainted by Morgan Stanley's own financial interests in promoting the business of its investment banking customers. Plaintiffs alleged that Morgan Stanley breached its contracts with the plaintiffs by failing to provide objective investment advice. Looking beyond the plaintiffs' characterization of their claims, Southern District Judge Charles S. Haight Jr. reasoned that their complaint must be read to allege that the defendant's description of its brokerage services fraudulently omitted material information concerning the relationship between its investment banking and research departments. He concluded that "Plaintiffs' claim is a securities fraud wolf dressed up in a breach of contract sheep's clothing."[10]

B. Covered Actions. SLUSA applies only to actions brought by or on behalf of more than 50 persons,[11] but courts have rebuffed the efforts of plaintiffs to circumvent this requirement though procedural maneuvers.[12] In a recent decision in *Lee v. Marsh & McLennan Companies*,[13] Southern District Judge Shirley Wohl Kram rejected an argument that plaintiffs had engaged in such impermissible maneuvering when they dismissed their first complaint brought on behalf of 58 persons, and 10 days later refiled two new actions naming a total of only 38 plaintiffs. Among the reasons proffered for the reduction in plaintiffs was that some names had been duplicated in the initial complaint (one individual was named three times), one was deceased, and some of the original plaintiffs did not actually own the stock in question. Recognizing that a reduction in the number of plaintiffs bringing the action beyond SLUSA's reach might "raise the specter of impermissible gamesmanship," Judge Kram nevertheless remanded the action to state court after concluding that plaintiffs' decision to drop at least 19 names from the case rested on "sound legal footing."

Class Action Fairness Act

CAFA was enacted just over two years ago to redirect class action litigation from state to federal court based in part on Congress' concern that the state courts sometimes had demonstrated

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bias against out-of-state defendants.[14] CAFA expands diversity jurisdiction to provide original jurisdiction over certain class actions involving 100 or more class members where only one plaintiff is diverse from one defendant and the aggregate amount in controversy is at least $5 million.[15] Notwithstanding this powerful mechanism designed to draw more cases into federal court, two recent Second Circuit decisions and one from the Southern District of New York have found jurisdiction under CAFA lacking.

A. Burden of Proof. In *Blockbuster, Inc. v. Galeno*,[16] the Second Circuit held that CAFA did not modify the traditional rule that the party seeking to invoke federal jurisdiction bears the burden of establishing that jurisdiction is proper. Blockbuster had removed to federal court this class action challenging as deceptive a program (touted as a "no late fee" program) under which Blockbuster, without notice, charged customers with the purchase of rented videos that were returned beyond their due dates. The plaintiff sought remand asserting that Blockbuster could not show that there was $5 million in controversy. After considering an in camera submission from Blockbuster concerning fees received from customers as a result of the challenged program, and without making specific findings regarding the amount in controversy, the district court denied the remand motion with language suggesting that plaintiff bore the burden of proving a lack of jurisdiction.

In vacating that decision, the Second Circuit rejected Blockbuster's assertion that CAFA had "altered the landscape of federal jurisdiction" by shifting the burden of proving a lack of jurisdictional facts to the plaintiff seeking remand of a class action removed under the act. In so doing, it disregarded explicit language in the CAFA Senate Committee Report that "[i]f a purported class action is removed pursuant to these jurisdictional provisions, the named plaintiff(s) should bear the burden of demonstrating that the removal was improvident (i.e., that the applicable jurisdictional requirements are not satisfied)."[17] Noting that this report was issued 10 days after CAFA was enacted, and that the statute itself contained no language shifting the long-established burden of proof, the court held that the burden remained with the defendant to prove a reasonable probability that the amount in controversy exceeded $5 million.

B. Amount in Controversy. In *DiTolla v. Doral Dental IPA of New York, LLC*,[18] another decision focusing on the $5 million amount in controversy requirement, the Second Circuit affirmed a district court order remanding that action to state court because the amount in controversy was indeterminable and thus not subject to removal under CAFA.[19] The plaintiff had brought an action in state court on behalf of himself and similarly situated dentists, seeking an accounting from the third-party administrator of a pool from which dentists who treat patients under Medicaid and Medicare are compensated. Plaintiff alleged that the defendants were under federal investigation for having deducted improper consulting fees from similar pools administered in other states.

Although the complaint sought only an accounting and did not seek any damages or restitution, the defendants asserted upon removal that they could satisfy the $5 million amount in controversy requirement because plaintiff had put at issue the entire amount by which the pool had been funded and reduced during the period in question (estimated at $40 million). The Second Circuit noted that the Supreme Court has instructed that in other types of equitable actions, such as those seeking declaratory or injunctive relief, the amount in controversy is to be measured by the value of the object of the litigation.[20]

It observed, however, that assigning a monetary value to an action for an accounting is not a straightforward matter. It rejected the notion that simply by asserting a beneficial interest in the pool, the plaintiff had placed the entire pool in controversy. Because any claim he might have to some portion of the pool was contingent on the outcome of the accounting, the court held that the amount in controversy was indeterminable, and thus failed to satisfy CAFA's jurisdictional requirements.

C. Local Controversy Exception. CAFA contains three exceptions to the exercise of federal jurisdiction for actions which otherwise meet its jurisdictional requirements. Under the "local controversy" exception, where more than two-thirds of the members of the plaintiff class and at least one "significant" defendant are citizens of the state in which the action was filed, and the principal injuries also occurred in that state, the district court must decline jurisdiction if no other class action asserting similar factual allegations against any of the defendants has been filed in the past three years.[21] The court must also decline jurisdiction under the "home state controversy" exception where more than two-thirds of the class and the primary defendants are citizens of the forum state.[22] Finally, the district court may decline jurisdiction, "in the interests of justice and looking at the totality of the circumstances," in an action where more than one-third of the plaintiff class and the primary defendants are citizens of the state in which the action was filed, based on consideration of six factors which seek to assess the local interest in the controversy.[23]

Southern District Judge Denny Chin invoked the "local controversy" exception in dismissing *Mattera v. Clear Channel Communications, Inc*.[24] The plaintiff had filed that class action in federal court asserting that the defendants, as owners and operators of New York radio stations, had violated the New York Labor Law by making unauthorized deductions from the wages of their sales representatives through charge backs of commissions paid on delinquent accounts. Defendants moved to dismiss for failure to join an indispensable party, Capstar, a New York citizen. Judge Chin held that Capstar was the employer of a significant number of the current sales representatives, and was, as such, an indispensable party under Rule 19(b), whose joinder destroyed complete diversity. Defendants then asserted that plaintiff's attempt to support jurisdiction under CAFA was barred under the local controversy exception.

As a preliminary matter, Judge Chin held that where a plaintiff seeks to invoke federal jurisdiction under CAFA and the defendant raises one of its exceptions, the defendant should bear the burden of proving that the exception applies.[25] He went on to hold that the defendants had met that burden in this case. He reasoned that although the defendants had not provided evidence to support their contention that more than two-thirds of the plaintiff class were citizens of New York, it was reasonably likely that this was the case because the class members all worked in New York. He found that the second requirement for the exception was satisfied because Capstar, a New York citizen, employed and paid most of the plaintiff sales representatives and thus made and retained the disputed charge backs. Similarly, because the harm alleged was a violation of New York's Labor Law and harmed employees of New York stations, he concluded that the principal injuries occurred in New York. Finally, because no suit alleging similar allegations had been filed against the defendants or Capstar, the local controversy exception applied. In the alternative, Judge Chin concluded that the case should be dismissed in the interests of justice, after consideration of the factors delineated in 28 USC §1332(d)(3).

Conclusion

Despite the explicit broadening of federal jurisdictional reach in SLUSA and CAFA, these recent decisions indicate that courts are continuing to exercise caution in construing federal jurisdiction. In cases falling at the margins of these statutes, plaintiffs determined to stay in state court may be able to style their complaints so as to avoid removal to federal court, and defendants seeking to avoid federal jurisdiction may well continue to succeed in doing so.

1. Pub. L. No. 105-353, 112 Stat. 3227 (codified in part at 15 USC §§77p & 78bb(f)).
2. Pub. L. No. 109-2, 119 Stat. 4 (codified in part at 28 USC §1332(d)).
3. Pub. L. No. 104-67, 109 Stat. 737 (codified in part at 15 USC §§77z-1 & 78u-4). See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 US 71 (2006).
4. 15 USC §§77p(b) & 78bb(f)(1).
5. 15 USC §§77p(c) & 78bb(f)(2).
6. *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F3d 116, 123 n.5 (2d Cir. 2003).
7. 547 US 71 (2006).
8. 2006 WL 1292828 (SDNY May 11, 2006).
9. 429 F. Supp. 2d 684 (SDNY 2006).
10. Id. at 693.
11. 15 USC §§77p(f)(2)(A) & 78bb(f)(5)(B).
12. See, e.g., *In re WorldCom, Inc. Sec. Litig.*, 2004 WL 692746 (SDNY April 2, 2004) (Cote, J.). See also Senate Banking Committee Report instructing that SLUSA be "interpreted broadly to reach mass actions and all other procedural devices that might be used to circumvent [its dictates]." S. Rep. No. 105-182, at 8 (1998).
13. 2007 WL 704033 (SDNY March 7, 2006).
14. Pub. L. No. 109-2, §2(a)(4), 119 Stat. 4, 5. Congress also expressed concern that in the state system, the interests of plaintiff class members are often subordinated to the interests of class counsel and that "state courts freely issue rulings in class action cases that have nationwide ramifications, sometimes overturning well-established laws and policies of other jurisdictions." S. Rep. No. 109-14, at 4 (2005).
15. 28 USC §1332(d). The statute also permits a defendant to remove a covered class action to federal court (a) even if a co-defendant is a citizen of the state in which the action was brought, and (b) without the consent of the other defendants in the case. 28 USC §1453(b).
16. 472 F3d 53 (2d Cir. 2006).
17. S. Rep. No. 109-14, at 42.
18. 469 F3d 271 (2d Cir. 2006).
19. CAFA alters the general rule set forth in 28 USC §1447(d) that decisions remanding cases to state court for lack of jurisdiction are not reviewable, see, e.g., *Kircher v. Putnam Funds Trust*, 126 SCt 2145 (2006), by providing that courts of appeal may accept appeals from orders granting or denying remand of a class action. 28 USC §1453(c)(1).
20. 469 F3d at 276 (citing *Hunt v. Wash. State Apple Adver. Comm'n*, 432 US 333 (1977)).
21. 28 USC §1332(d)(4)(A).
22. 28 USC §1332(d)(4)(B).
23. 28 USC §1332(d)(3).
24. 2006 WL 3316967 (SDNY Nov. 14, 2006).
25. In *Blockbuster*, the Second Circuit expressly declined to consider the allocation of burdens in applying the CAFA exceptions. 472 F3d at 58.