

SOUTHERN DISTRICT CIVIL PRACTICE ROUNDUP

Expert Analysis

Who Would Have Thought? Removal Of Non-Diverse State Law Claims

One of the most important battles in some cases is fought at the outset—over whether the case will be litigated in a state or federal forum. State-court defendants often scour state-law claims for a federal question supporting removal under 28 U.S.C. §1331. They have been aided to a limited extent by the Supreme Court’s 2005 decision in *Grable & Sons Metal Products v. Darue Engineering & Manufacturing*,¹ which propped open the door to removal under Section 1331 for a “special and small”² category of state-law claims brought by non-diverse parties in which important federal issues are embedded. Courts have emphasized that this category of removable cases is “slim.”³ But, as demonstrated by Southern District Judge Paul Gardephe’s recent decision permitting removal of legal malpractice claims in *Reserve Management v. Willkie Farr & Gallagher*,⁴ the opening identified in *Grable* provides room for creative lawyers to squeeze through the federal courthouse door in some cases traditionally thought to be within the exclusive province of state courts.

Embedded Federal Issue

In *Grable*, the Supreme Court considered when a federal court has subject matter jurisdiction over “federal issues embedded in state-law claims between non-diverse parties.”⁵ In that case, the Internal Revenue Service had seized and auctioned to defendant Darue a piece of real property belonging to petitioner Grable in order to satisfy Grable’s tax delinquency. Under the relevant tax provision requiring the IRS to give Grable notice of the seizure, the IRS notified Grable by certified mail before the property was sold. Arguing that the



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federal notice statute required personal service, rather than service by mail, *Grable* brought a quiet title action in state court five years after the sale, claiming that Darue’s title was invalid because the IRS had not complied with the notice statute. Darue then removed the case to federal court.

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In examining whether removal was proper, the court rejected the argument that a corresponding federal right of action was required for the assertion of federal jurisdiction over state-law claims.⁶ Rather, as framed by the court in *Grable*, the proper jurisdictional question is “does a state-law claim necessarily raise a stated federal issue, actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance of federal and state judicial responsibilities.”⁷

Applying this test, the court found that the federal issue raised by Grable’s claim—whether he was given notice within the meaning of the federal statute—was the only legal or factual dispute in the case. The court characterized interpretation of the federal tax provision as an important issue which “sensibly belong[ed] in a federal court,” noting

the strong government interest in the collection of taxes and the concurrent need for a federal forum to vindicate administrative actions. As to the balance of federal and state responsibilities, the court concluded that because quiet title actions will only rarely raise contested matters of federal law, “federal jurisdiction to resolve genuine disagreement over federal tax title provisions will portend only a microscopic effect on the federal-state division of labor.”⁸ In so holding, the court drew an express contrast to state tort law, noting the “enormous shift of traditionally state cases into federal courts” which would arise if federal jurisdiction were exercised over state tort claims where negligence was predicated on the violation of a federal statute or regulation.⁹

Courts in the U.S. District Court for the Southern District of New York have taken a conservative view of removal jurisdiction under *Grable*, ordering remand where the proffered federal issue is merely a defense¹⁰ or where the federal issue, even if necessarily raised, was insubstantial.¹¹ Where one case upheld removal of a breach of contract claim which turned on whether the contract complied with the Medicaid laws,¹² another has warned against the temptation “to find federal jurisdiction every time a multi-billion dollar case with national implications arrives at the doorstep of a federal court.”¹³ Southern District judges appear to have largely resisted that temptation. Gardephe’s decision in *Reserve Management* is thus a relatively rare instance where *Grable* has been used to expand federal jurisdiction into new territory.

‘Reserve Management’

Although *Grable* singled out tort claims as distinctly ill-suited for the exercise of “arising under” jurisdiction, Gardephe nevertheless determined that the legal malpractice claims in *Reserve Management* rested upon sufficiently important questions of federal law to satisfy the exacting requirements for jurisdiction under Section 1331.¹⁴ In a complaint originally filed in state court,

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Reserve Management (RMCI), an investment advisor to a fund that collapsed in the wake of the Lehman Brothers bankruptcy, initially sued the law firm of Willkie Farr & Gallagher under two broad theories of liability. First, RMCI alleged that based on Willkie's improper advice, it took certain actions for which the Securities and Exchange Commission then sought to hold RMCI liable. It claimed that, but for this advice, RMCI would not have been sued either by the SEC or by private parties and so would not be incurring the attendant attorney fees and other defense costs associated with those still pending actions.¹⁵

Second, RMCI alleged that Willkie failed to disclose the conflict created by its simultaneous representation of both RMCI and the fund. Specifically, RMCI asserted that by virtue of this conflict, Willkie failed to advise RMCI to request that the fund indemnify RMCI against third-party claims and attorney fees incurred in defense of such actions. RMCI alleged that this failure led to the loss of millions of dollars for which it would have been indemnified had Willkie properly advised it.

In determining whether RMCI's claims fell within the slim category of state-law claims which under *Grable* raise federal issues sufficient to support jurisdiction under Section 1331, Gardephe looked first to the elements of a legal malpractice claim under New York law: (1) a duty, (2) a breach of that duty, and (3) proof that actual damages

held, sufficed under *Grable* to show that the state-law claim necessarily raised a federal issue.¹⁶

Gardephe rejected RMCI's argument that its potential violation of federal securities laws was only an affirmative defense to be established at trial, and thus incapable of supporting federal jurisdiction. He found instead that RMCI must prove that it had not violated the securities laws as part of its prima facie case that its injury from the lack of indemnity was proximately caused by Willkie, observing that RMCI had itself repeatedly alleged in its complaint that it was in compliance with federal securities laws.

Turning to RMCI's second theory of liability, Gardephe found that RMCI's theory of improper advice also necessarily raised a federal issue. Specifically, RMCI claimed that the SEC sought to hold it responsible for actions either taken by Willkie directly or based on Willkie's advice. Gardephe reasoned that in order to show that RMCI would not have incurred the defense costs associated with the SEC's investigation but for Willkie's alleged malpractice, RMCI would have to demonstrate that it had not committed other federal securities violations which might have provoked the SEC's investigation and suit.

With respect to the second prong of *Grable*—whether the federal issues implicated by the case were substantial and disputed—RMCI argued that the federal questions were both fact-based and

Gardephe found support for his approach in cases from other circuits permitting removal of legal malpractice claims arising out of patent cases which turn on underlying questions of patent law. The courts in those cases gave weight to the fact that federal courts have exclusive jurisdiction over patent law, much as they do over questions of securities law.¹⁹ Finally, Gardephe observed that removal in *Reserve Management* would be consistent with the U.S. Court of Appeals for the Second Circuit's decision in *Achtman v. Kirby, McInerney & Squire*,²⁰ approving the exercise of supplemental jurisdiction over a legal malpractice claim related to securities litigation. He accordingly denied the motion to remand.

Conclusion

Although the category of state-law-based cases that can be removed under *Grable* remains quite narrow, Gardephe's decision in *Reserve Management* should encourage state court defendants seeking a way into federal court to think aggressively about potential federal issues embedded in the state law claims. Conversely, plaintiffs wishing to secure a state court forum should be careful not to open the door to removal of traditional state law claims through reference to federal law in their pleadings that might otherwise be avoided.

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1. 545 U.S. 308 (2005).
2. *Empire Healthchoice Assurance v. McVeigh*, 547 U.S. 677, 699 (2006).

3. *Id.* at 701.
4. 2012 WL 4378058 (S.D.N.Y. Sept. 25, 2012) (Gardephe, J.).
5. 545 U.S. at 314.
6. *Id.* at 316 (discussing its earlier decision in *Merrell Dow Pharmaceuticals v. Thompson*, 478 U.S. 804 (1986)).

7. *Id.* at 314.
8. *Id.* at 314-15.
9. *Id.* at 315, 319.
10. *Citigroup v. Wachovia*, 613 F.Supp.2d 485, 496 (S.D.N.Y. 2009) (Scheidlin, J.).

11. *In re OxyContin Antitrust Litig.*, 821 F.Supp.2d 591, 599 (S.D.N.Y. 2011) (Stein, J.). See also *Greenwich Fin. Svcs. Distressed Mortgage v. Countrywide Fin.*, 654 F.Supp.2d 192, 203 (S.D.N.Y. 2009) (Holwell, J.) (no removal jurisdiction where relevant federal statutes did not create private right of action).

12. *N.Y.C. Health and Hosp. Corp. v. Wellcare of N.Y.*, 769 F.Supp.2d 250 (S.D.N.Y. 2011) (Scheidlin, J.).

13. *Greenwich Fin. Svcs.*, 654 F.Supp.2d at 204.
14. 2012 WL 4378058.

15. The SEC enforcement action and civil proceedings against RMCI are all consolidated before Judge Gardephe.

16. *Id.* at *6.

17. *Id.*

18. *Id.* at *7.

19. See, e.g., *USPPS v. Avery Dennison*, 647 F.3d 274, 281-82 (5th Cir. 2011) (finding federal jurisdiction where legal malpractice claim required resolving patent questions, despite prior precedent dismissing a malpractice claim for want of jurisdiction where underlying representation was based in trademark); *Air Measurement Techs. v. Akin Gump Strauss Hauer & Feld*, 504 F.3d 1262, 1269 (Fed. Cir. 2007) (upholding removal where resolution of malpractice claim required resolution of a "substantial patent question"). See also *Mr. Bar-B-Q v. Natter & Natter*, 2011 WL 2015574 (S.D.N.Y. May 18, 2011) (Swain, J.) (remanding malpractice claims arising from trademark advice because federal jurisdiction in trademark cases is concurrent rather than exclusive).

20. 464 F.3d 328 (2d Cir. 2006).

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were proximately caused by the breach of duty. He stressed that to show proximate cause, the malpractice plaintiff must demonstrate that, but for the attorney's negligence, the plaintiff would have prevailed in the underlying action or would not have sustained any ascertainable damages.

Gardephe then considered the first prong of *Grable*'s test—whether a federal issue was necessarily raised by the malpractice claim—by examining the interaction between the but for causation requirement of New York tort law and the federal securities laws that Willkie argued were necessarily raised by the case. With respect to the theory that RMCI would have been indemnified but for the alleged conflict, he noted that the Exchange Act of 1940 prohibits funds from indemnifying investment advisors against willful malfeasance, bad faith, or gross negligence. As a result of this prohibition, Gardephe found that RMCI would have to show that it did not violate federal securities laws in order to prove proximate cause. This, in turn, he

insignificant. Gardephe rejected this contention, finding that the question of whether RMCI had violated federal securities laws presented "a number of hotly disputed legal issues, including what misstatements and omissions may form the basis for a claim under" the securities laws.¹⁷

Gardephe then considered the third prong of *Grable*—whether the federal issues could be considered without disturbing any congressionally approved balance of federal and state judicial responsibilities. He found that the relevant federal interest was strong, pointing to the comprehensive federal securities regime granting exclusive jurisdiction to federal courts over federal securities laws. Responding to *Grable*'s concern that exercising federal jurisdiction over state tort claims might create an imbalance in the traditional division of responsibility for such cases, Gardephe found no reason to believe that permitting removal of this case would "open the floodgates" to federal courts.¹⁸