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Untangling a Statutory Web

Arguing conflicting jurisdictional provisions for Securities Act class actions after CAFA.

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IT IS A FAMILIAR maxim in civil litigation that *where* plaintiffs may sue often dictates *how* they may sue. This is particularly true in the area of securities class action lawsuits. Strict federal reforms have increasingly led plaintiffs to seek to bring their claims in state court, where they are often subject to less stringent pleading requirements and other standards that could have a significant impact in determining the outcome of such cases.

In the wake of the recent financial and credit markets crisis, courts nationwide have had to confront a wave of securities class actions. Some of these have involved the publicly traded securities of well-known companies, but many concern lesser-known investments such as mortgage-backed securities that have come to symbolize the recent era of exuberance in the financial markets.

While securities class actions involving publicly traded securities are ordinarily removable to federal court, the proper forum for class actions involving securities that are not traded on a national exchange is open to debate and is the subject of a brewing circuit split.

At the heart of this dispute is a conflict between the Securities Act of 1933 (Securities Act), passed in the midst of the last great financial crisis, and the Class Action Fairness Act (CAFA), a statute passed in 2005 aimed at curbing abuses in the class action process.

While the Securities Act generally provides that actions arising under it and brought in state court are not removable to federal court, defendants have argued that CAFA, which expanded federal jurisdiction over certain class actions, trumps the Securities Act in this regard. The courts are currently split on this question. The Ninth Circuit has held for plaintiffs and against removal; more recently, the Seventh Circuit and at least one other court have held for defendants and in favor of removal.

This article examines the background and significance of the conflict between the Securities Act and CAFA. This article also discusses the major cases to address this conflict, and examines one of the exceptions to CAFA that plaintiffs have attempted to invoke in favor of having their cases remanded to state court.

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The Statutory Landscape

The Securities Act. Among the Securities Act's most important provisions, §§11 and 12 provide for potential civil liability for material misstatements or omissions in, respectively, a registration statement or a prospectus issued in conjunction with a security sold in a public offering.

Of course, the Securities Act is a federal law, and the general rule is that federal courts have jurisdiction over actions arising either under federal law or in cases where the parties are geographically diverse from one another and the amount in controversy exceeds $75,000. Moreover, federal statute has long provided that any action brought in a state court over which a federal court would have jurisdiction may be removed to federal court.

However, Congress specifically carved out an unusual exception to this rule in the Securities Act, providing that "[n]o case arising under [the Securities Act] and brought in any State court of competent jurisdiction shall be removed to any court of the United States."[1] Thus, under the strict terms of the Securities Act, a plaintiff could bring suit under that act in federal court or rely upon its anti-removal provision to bring a suit in state court and to keep it there.

The PSLRA and SLUSA. Passed in 1995 to curb abuses in the securities class action arena, the Private Securities Litigation Reform Act of 1995 (PSLRA) imposed reforms on federal securities class action lawsuits that included heightened pleading requirements, safe harbors for certain forward-looking statements, changes in the discovery process and selection of class representatives.

Given the heightened hurdles they faced in federal court, it was only natural that plaintiffs increasingly sought to bring securities class actions in state courts, often perceived as friendlier to plaintiffs' claims. But Congress partially closed that door in 1998 when it passed the Securities Litigation Uniform Standards Act (SLUSA), which provides that any "covered class action brought in any State court involving a covered security" is removable to federal court. Under SLUSA, a covered class action means essentially any class action of at least 50 members. A security is considered "covered" if it is traded nationally and listed on a regulated national exchange.[2]

A number of courts have held that SLUSA permits removal to federal court of a "covered class action," including Securities Act class actions, involving a "covered security."[3] Other courts, sometimes relying on narrower readings of SLUSA, have disagreed and held that under it such claims are not removable.[4] However, while some doubt remains as to the scope of SLUSA, there is no doubt that it does not address actions involving securities that are not "covered," i.e., those that are not traded on a national stock exchange.[5]

As the recent financial crisis has brought a flood of cases involving mortgage-backed securities and other more esoteric investments, which are generally not "covered securities" under SLUSA given that these securities do not trade on a national exchange, the question of whether cases involving these types of securities may be removed to federal court has become a hot-button issue that courts have struggled to address.[6] As they have done so, these courts have had to confront yet another reform statute passed by Congress, CAFA.

CAFA. Passed in 2005 after years of debate centered largely on abuses in state court tort actions and the associated forum shopping that such abuses encouraged, CAFA expanded federal jurisdiction over certain class actions. CAFA provides in relevant part that federal district courts have "original jurisdiction of any civil action in which the matter in controversy exceeds the sum or value of $5,000,000…and is a class action in which… any member of a class of plaintiffs is a citizen of a State different from any defendant." CAFA, however, does not apply to certain class actions, including actions involving covered securities (those traded on a national exchange) that Congress addressed in SLUSA.[7]

Defendants in securities class actions involving non-covered securities have relied on CAFA in arguing that their cases are removable to federal court. In response, plaintiffs have pointed to the Securities Act's non-removal provision. How to resolve the conflict between the two has divided the courts, with some asking which statute more specifically governs the issue and others looking more to the overall purposes of CAFA's reform mandate and the presumption that a newer law trumps an older one.

Ninth Circuit Sides With Plaintiffs

Luther v. Countrywide[8] was a class action alleging violations of the Securities Act based on an allegedly false registration statement and prospectus issued in conjunction with an offering of mortgage pass-through certificates from defendant Countrywide, the now-famous home lender.

Plaintiff filed the action in state court; the defendants, citing CAFA, removed the case to federal court, and plaintiff moved to remand. The district court granted plaintiff's remand motion on the rationale that CAFA's provision for removal of class actions of sufficient size and diversity, on the one hand, and the non-removal provision of the Securities Act, on the other, "cannot mutually coexist" and that the "specific bar against removal in the [Securities] Act trumps CAFA's general grant of diversity and removal jurisdiction." Countrywide appealed to the Ninth Circuit.

The circuit court attempted to resolve the conflict by asking which statute was more specific as to the issue of removability. It held that in this regard the Securities Act prevailed over CAFA because, unlike CAFA, the Securities Act's non-removability provision applies only to cases brought under the Securities Act. In other words, the Securities Act, as the more specific statute, trumps CAFA, which addresses class actions generally.

Seventh Circuit, SDNY Beg to Differ

In early 2009, the Seventh Circuit weighed in on the conflict in a Securities Act class action brought on behalf of holders of units in a real estate investment trust.

In that case, *Katz v. Gerardi*,[9] which was initially filed in state court and removed to federal court by defendants, the district court invoked the logic of the Ninth Circuit's *Luther* opinion and held that the case should be remanded to state court. However, in an opinion by Judge Frank Easterbrook, the Seventh Circuit took on *Luther* directly.

It reasoned that the specificity approach taken by *Luther* was inapplicable to this statutory conflict because the non-removability provision of the Securities Act was not a mere "subset" of CAFA. Rather, the court noted that the Securities Act anti-removal provision includes all types of securities actions, including single-investor suits, small class actions and large multi-state class actions, whereas CAFA, in contrast, covers only large, multi-state class actions.

Thus, the court asked, "Is the [Securities] Act more specific because it deals only with securities law, or is [CAFA] more specific because it deals only with nationwide class actions?" Finding no answer to that question, the court concluded that the canon favoring the specific law over the general one would not solve the problem. Rather, the Seventh Circuit found more clarity in the maxim that an older law generally yields to a newer one.

The court also reasoned that language in the exceptions to CAFA clearly implied that the act affected at least some securities cases, and chided the Ninth Circuit for not analyzing that language. Accordingly, the Seventh Circuit held that securities class actions involving non-covered securities, and not falling within an exception to CAFA, are removable if they meet CAFA's requirements: at least $5 million in controversy, 100 investors, and minimal diversity.

Around the same time the Seventh Circuit was considering *Katz*, the Southern District of New York was called upon to resolve this conflict in *NJ Carpenters Vacation Fund v. Harborside Mortgage Loan Trust*,[10] another class action concerning mortgage loan pass-through certificates. The action had been filed in state court and removed by defendants to federal court.

In considering the conflict between the Securities Act and CAFA, the court looked by analogy to the 2004 *WorldCom* case[11] in which the Second Circuit analyzed a conflict between the Securities Act's anti-removal provision and the federal bankruptcy code, which provides for removal of cases in or related to bankruptcy. In *WorldCom*, the Second Circuit focused on the purpose of the bankruptcy code in centralizing bankruptcy litigation in a federal forum and found that this purpose overrode the anti-removal provision of the Securities Act.

Applying a similar type of analysis to CAFA, the Southern District in *Harborside* turned to *Estate of Pew v. Cardarelli*, a 2008 Second Circuit opinion, which was not a Securities Act case, but which did provide the Circuit an opportunity to weigh in on the overall purpose of CAFA. There, the Second Circuit held that a "review of…CAFA confirms an overall design to assure that the federal courts are available for all securities cases that have national impact…without impairing the ability of state courts to decide cases of chiefly local import or that concern traditional state regulation of the state's corporate creatures."[12]

> At the **heart** of this **dispute** over the proper forum for class actions involving securities **not traded** on a national exchange, which is the subject of a brewing **circuit split**, is a conflict between the Securities Act of **1933** and the **2005** Class Action Fairness Act.

Finding that this purpose expressed by Congress in CAFA overrides the Securities Act's anti-removal provision, the *Harborside* court held that the case was removable. The court also noted that the action at hand involved "exactly the type of case CAFA was concerned about—a large, non-local securities class action dealing with a matter of national importance, the mortgage-backed securities crisis that is currently wreaking havoc with the national and international economy."

Turning to CAFA's Exceptions

Given that several courts have found that CAFA applies to a Securities Act class action involving a security not "covered" under SLUSA, plaintiffs are likely to litigate the various exceptions under CAFA.

Perhaps the most germane of these exceptions to class actions brought under the Securities Act is CAFA's provision that the federal courts do not have jurisdiction over a class action that "solely involves a claim…that relates to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security…" Plaintiffs may attempt to override CAFA to get back to state court by arguing that their cases implicate such rights, duties, and obligations.

The Second Circuit examined this CAFA exception in *Greenwich Financial Services v. Countrywide Financial*,[13] a decision issued in April 2010, and held for plaintiffs that their case (which was not a Securities Act case) fell within this exception. However, it appears from the circuit's discussion of this exception that it will not assist plaintiffs seeking the remand of an ordinary Securities Act class action brought under §§11 or 12.

In particular, the plaintiffs in *Greenwich* sued to enforce the terms of pooling and servicing agreements that governed mortgage-trust certificates, which agreements required Countrywide to repurchase modified loans from the trusts at a price equal to their unpaid principal plus any accrued interest. The Second Circuit held that this action fell under the CAFA exception because it sought to enforce the terms of instruments that create or define securities.

While litigants may well attempt to shoehorn their cases within this exception, they are unlikely to be successful for ordinary securities class actions alleging fraudulent statements or omissions in offering documents. As the Southern District recognized in *Harborside*, the CAFA exception at issue should apply to "disputes over the meaning of the terms of a security," which would not generally apply to a case alleging false or misleading statements in the offering documents.

Similarly, in *Estate of Pew*, the Second Circuit held that the CAFA exception applies to suits "grounded in the terms of the security itself" and does not apply to suits claiming that a "security was fraudulently marketed."

Conclusion

While it is always difficult to predict the future of the legal landscape, the trend demonstrated by *Katz* and *Harborside* suggests that forthcoming opinions may favor defendants.

As one district court in the Third Circuit recently put it, albeit in dicta because the case was not a class action, "[a]lthough not free from doubt, it appears that CAFA may trump the anti-removal statute, so that if a case is a covered class or 'mass action' under CAFA, the anti-removal provision of [the Securities Act] does not apply."[14]

1. 15 U.S.C. §77v(a).
2. See 15 U.S.C. §77r(b).
3. See, e.g., *In re Fannie Mae 2008 Securities Litigation*, 2009 WL 4067266 (S.D.N.Y. Nov. 24, 2009); *Knox v. Agria Corp.*, 613 F. Supp. 2d 419 (S.D.N.Y. 2009); *Rubin v. Pixelplus Co., Ltd.*, 2007 WL 778485 (E.D.N.Y. March 13, 2007).
4. See *Unschuld v. Tri-S Security Corp.*, 2007 WL 2729011 (N.D. Ga. Sept. 14, 2007); *Irra v. Lazard Ltd.*, 2006 WL 2375472 (E.D.N.Y. Aug. 15, 2006).
5. See James E. Brandt and Eric S. Olney, "Removal of Class Action Securities Cases in the Age of CAFA," Bloomberg Law Reports (2009).
6. See Denise Mazzeo, Note, "Securities Class Actions, CAFA, and a Countrywide Crisis: A Call for Clarity and Consistency," 78 Fordham L. Rev. 1433 (2009).
7. See 28 U.S.C. §§1332(d)(9) and 1453(d).
8. 533 F.3d 1031 (9th Cir. 2008).
9. 552 F.3d 558 (7th Cir. 2009).
10. 581 F. Supp. 2d 581 (S.D.N.Y. 2008).
11. 368 F.3d 86 (2d Cir. 2004).
12. 527 F.3d 25, 32 (2d Cir. 2008).
13. 603 F.3d 23 (2d Cir. 2010).
14. *Federal Home Loan Bank of Pittsburgh v. J.P. Morgan Securities Inc.*, 2009 WL 5178904 (W.D. Pa. Dec. 21, 2009).