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Second Circuit, in Case of First Impression, Interprets Class Action Fairness Act to Provide Federal Jurisdiction for State Law Consumer Fraud Action Not Involving Nationally Traded Securities

The latest case in the continuing interpretation of the Class Action Fairness Act by Circuit Courts of Appeal holds that a state law deceptive practices claim related to the sale of a security does not fall within one of CAFA's exceptions, and is removable under CAFA so long as the standard requirements are satisfied. Stating that "the question of whether a state-law deceptive practices claim predicated on the sale of a security is removable under CAFA is important and consequential, and a decision of the question will alleviate uncertainty in the district courts," the Second Circuit resolved this case of first impression on May 13, 2008 in *Estate of Pew v. Cardarelli*, No. 06-5703.

Estate of Pew presented the issue of whether federal jurisdiction existed over a class action complaint based solely on the New York State consumer fraud statute and involved money market certificates — unsecured, fixed-interest debt instruments — which were not nationally traded securities. The Complaint had been filed in New York State Supreme Court and removed to federal court. The action alleged that officers of an issuer — abetted by the issuer's auditor — failed to disclose, while marketing the debt certificates, that the issuer was insolvent. The U.S. District Court for the Northern District of New York ruled that CAFA did not provide for federal jurisdiction and remanded the case. In its May 13, 2008 decision, the Second Circuit stated the issue as follows:

The main question for this appeal is whether such a claim falls within an exception to CAFA's grant of original and appellate jurisdiction—for class actions that solely involve claims that 'relate[] to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security.' 28 U.S.C. § 1332(d)(9)(c); *id.* § 1453(d)(3). This is a question of first impression in the circuit courts.

Slip Op. at 3, 4.

The panel's majority found that the exception was inapplicable to the case and that "the action falls within the grant of federal jurisdiction in the Class Action Fairness Act." *Id.* at 2. The remaining judge on the panel vigorously disagreed and issued a strongly-worded dissent.

Framework of the Expansion of Federal Jurisdiction under the Class Action Fairness Act

CAFA provided for a significant expansion of federal jurisdiction over class action claims when it was passed

by Congress in 2005. CAFA added a subsection to the statute delineating federal diversity jurisdiction giving the federal district courts "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" minimal diversity is present. 28 U.S.C. § 1332(d)(2). In addition, CAFA allowed for the removal of class actions from state courts to federal district courts "without regard to whether any defendant is a citizen of the State in which the action is brought." 28 U.S.C. § 1453(b).

In order to provide for the adjudication of issues solely of state concern, however, CAFA included three exceptions to its expansion of federal jurisdiction. First, the less stringent requirements for federal jurisdiction contained in CAFA do not apply to class actions that qualify for federal jurisdiction under other statutes, such as the Securities Litigation Uniform Standards Act which provides federal jurisdiction for state law fraud claims concerning the purchase or sale of nationally traded securities. Second, an action cannot obtain federal jurisdiction through the CAFA amendments if it arises out of the law of the state in which the company is organized and relates to the company's governance or internal affairs. Lastly, CAFA does not provide federal jurisdiction for any action that "relates to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security."

If an action falls under one of these three exceptions, the expanded federal jurisdiction provided by CAFA does not apply and federal jurisdiction will not lie unless traditional diversity or subject matter jurisdiction can be established.

Interpretation of the Third Exception to Federal Jurisdiction under CAFA

In *Estate of Pew*, the Second Circuit considered the application of these exceptions to federal jurisdiction under CAFA to plaintiffs' complaint alleging state law consumer fraud in the marketing and sale of the debt certificates. The court found that the first two exceptions stated in CAFA were not applicable because the debt certificates were not nationally traded and the allegations did not relate to the company's corporate governance. However, the district court had found the third exception precluded jurisdiction. In what it referred to as a question of first impression for the circuit courts,

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the Second Circuit considered whether the district court's application of the third exception to this type of action was appropriate.

Chief Judge Jacobs, writing for the majority consisting of himself and Judge Kearse, found the statutory language of the third exception to be ambiguous. Accordingly, the majority considered not only the wording of the section but the larger statutory context as well as CAFA's legislative history.

In the opinion, Judge Jacobs broke the exception down into four parts and determined that it could not be interpreted to apply to all claims relating to any security, as plaintiffs argued, because such an interpretation would leave the limiting language in the exception – “rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security” – without meaning. Slip Op. at 17-18. Taking this into account, the majority reasoned that the consumer fraud claims in the present action did not “relate to” the rights and obligations created by the securities because they were not “claims grounded in the terms of the security itself.” *Id.* at 19.

The majority also felt that both a contextual reading of the CAFA provision at issue and the statute's legislative history confirmed this interpretation of 28 U.S.C. § 1453(d)(3). *Id.* at 21. In particular, the court focused on language from a Senate Report (filed ten days after the bill was passed, as the plaintiffs pointed out) explaining that the exception was intended to apply to claims involving “rights arising out of the terms of the securities issued by business enterprises” and “disputes over the meaning of the terms of a security[.]” *Id.* at 22 (quoting S. Rep. No. 109-14, at 45 (2005), reprinted in 2005 U.S.C.C.A.N. 3, 42-43 (2005)).

The panel found that the third exception to federal jurisdiction under CAFA applies “only to suits that seek to enforce the terms of instruments that create and define securities, and to duties imposed on persons who administer securities.” *Id.* at 23. Since the claims in *Estate of Pew* did not fall into either of those categories, removal to federal court under CAFA was proper and the district court's order to remand the case was reversed. *Id.*

The Dissenting Opinion

The third judge on the panel, Judge Pooler, stated her vigorous disagreement with the majority in a lengthy dissent that accuses the majority of “ignor[ing] the plain terms of CAFA.” *Id.* at 38 (Pooler, J., dissenting). In Judge Pooler's opinion, a claim of consumer

fraud arising out of the marketing and sale of the securities necessarily “relates to” the rights and obligations created by those securities as it bears on the plaintiffs' ability to collect the payments to which they are given a right under the securities. Judge Pooler labeled the majority's interpretation of the relevant provision as “an act of judicial re-drafting of CAFA.” *Id.* at 34. Judge Pooler stated that “all that matters is that the suit is one in which securities holders are seeking the enforcement of rights created by, or relating to, the securities they hold. If this condition is met, our inquiry is finished.” *Id.* at 34. She found the majority's “eccentric reading” of Section 1332 (d)(9)(C) rested upon “dubious legislative intent.” She concluded that “I believe the application of CAFA to the facts of the instant case leads to the straightforward conclusion that the district court correctly held that the case should be remanded to the state court.” She said “the majority has ignored the plain terms of CAFA, created its own waste space, and filled in the resulting gap with an unwarranted exercise of legislative power.” *Id.* at 38.

Impact of the Second Circuit's Decision on Removal of Class Actions under CAFA

The majority explained its decision to hear this appeal as stemming from a desire to “alleviate uncertainty in the district courts” on the issue of whether state law deceptive practices claims are removable to federal court under CAFA. *Id.* at 11. The business community and the Bar will be watching to see the impact of this decision. Subsequent cases will demonstrate whether the lack of a unanimous decision and the passion with which the dissenting panelist rejected the majority's reasoning will detract from the goal of alleviating uncertainty. This was a case of first impression. The court's decision undoubtedly will guide future class action lawsuits filed in the Second Circuit and will help to illuminate the issues courts will need to consider in future cases concerning the application of CAFA.

ABOUT THE AUTHORS

Thomas J. Cunningham, Jay G. Safer and Julie C. Webb represent banks, mortgage lenders, insurance companies and other financial institutions, as well as many other types of business clients, in state and federal courts throughout the country. They concentrate their practice in defending class-action litigation.