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## The Artful Dodgers: Securities Fraud, Artful Pleading, and Preemption of State Law Causes of Action Under the Securities Litigation Uniform Standards Act

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THE ARTFUL DODGERS: SECURITIES FRAUD, ARTFUL  
PLEADING, AND PREEMPTION OF STATE LAW CAUSES OF  
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STANDARDS ACT

*Gregory Kendall\**

I. INTRODUCTION

Although a main component of the regulatory scheme established by Congress to monitor the national securities markets is oversight and enforcement by the Securities and Exchange Commission (SEC), private shareholder litigation also has an important role to play in ensuring corporate accountability.<sup>1</sup> In an attempt to balance the policing and deterrence roles of private shareholder litigation with the interests of corporate actors in minimizing the threat of perpetual securities fraud litigation, Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Securities Litigation Uniform Standards Act of 1998 (SLUSA). The PSLRA imposes procedural burdens on securities class actions, and SLUSA precludes certain securities class actions from being brought in state court if the complaint alleges a misrepresentation or omission in connection with the purchase or sale of securities.

Because SLUSA's language does not limit its preemptive scope to formally pled fraud claims, a gray area has developed regarding how far SLUSA should be interpreted to preclude various state law causes of action where the plaintiff has alleged fraudulent conduct in the complaint. Furthermore, plaintiffs' lawyers have found creative ways to circumvent SLUSA—and thereby thwart the objectives of the PSLRA—through “artful pleading.”<sup>2</sup> The federal circuit courts have developed different standards for evaluating the nuances of the complaint to determine if the lawsuit is precluded by SLUSA, and, having made such a determination, whether and how to allow the non-precluded state law

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1. See James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 497 (1997) (“The class action thereby has an important deterrent feature which give [sic] it a quasi-public character; it can thus be seen as an extension of the state’s enforcement arm and an expression of society’s will.”).

2. The artful pleading doctrine states that “a plaintiff cannot frustrate a defendant’s right to remove by pleading a case without reference to any federal law when the plaintiff’s claim is necessarily federal.” CHARLES ALAN WRIGHT & ARTHUR R. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 3722 (4th ed. 2012). A state law claim that is completely preempted by federal law may be removed to federal court even if the complaint asserts only state law claims. 16–107 JAMES WM. MOORE ET AL., *MOORE’S FEDERAL PRACTICE* § 107.14[4][b][iv] (2012).

claims to proceed. Because these different standards are contrary to SLUSA's objective of maintaining uniform standards for private securities actions, the circuit split must be resolved by either adopting one approach or combining the approaches into a consistent standard.

Part II of this Comment provides an overview of the history of private securities litigation and discusses the substance and policy rationales of the PSLRA and SLUSA. Part III addresses both the varying standards adopted by the circuit courts in analyzing the pleadings to determine whether SLUSA applies to preempt state law claims, as well as the courts' different approaches regarding how a claim should proceed to disposition when SLUSA is deemed to apply to some or all of the claims. Part IV argues that the Third Circuit's approach is best suited to promote the objectives of the PSLRA and SLUSA while properly leaving purely state law causes of action outside of SLUSA's preemptive scope. Part V concludes the Comment.

## II. THE HISTORICAL CONTEXT: PRIVATE ACTIONS, PSLRA, AND SLUSA

### A. Securities Regulation and Private Rights of Action

In response to the collapse of the stock market in 1929, Congress enacted the Securities Act of 1933<sup>3</sup> and the Securities Exchange Act of 1934.<sup>4</sup> Section 10(b) of the 1934 Act prohibits the use of "any manipulative or deceptive practice or contrivance in contravention" of the rules promulgated by the Securities Exchange Commission (SEC) pursuant to the Act.<sup>5</sup> SEC Rule 10b-5 makes it unlawful for

any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>6</sup>

Although the 1934 Act grants authority to the SEC to bring civil actions in federal court to enforce the Act and the SEC's rules,<sup>7</sup> the federal courts have recognized an implied right of individuals to seek redress

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3. 15 U.S.C. § 77a (2012).

4. *Id.* § 78a.

5. *Id.* § 78j(b).

6. 17 C.F.R. § 240.10b-5 (2006).

7. 15 U.S.C. § 78u(d)(3)(A) (2010).

for securities fraud.<sup>8</sup> However, in *Blue Chip Stamps v. Manor Drug Stores*, the U.S. Supreme Court acknowledged that litigation under Rule 10b-5 presented “a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.”<sup>9</sup> The Court explained that even objectively baseless claims may force companies to settle if the pending lawsuit has the potential to “frustrate or delay normal business activity.”<sup>10</sup> These settlement amounts may be disproportionate to the plaintiff’s likelihood of success at trial.<sup>11</sup> Such lawsuits are referred to as “nuisance suits” or “strike suits.”<sup>12</sup>

### *B. The Private Securities Litigation Reform Act of 1995*

In 1995, Congress adopted the PSLRA<sup>13</sup> to address “perceived abuses of the class-action vehicle in litigation involving nationally traded securities.”<sup>14</sup> These abuses included reflexive filing of lawsuits in response to dramatic fluctuations in stock prices, extortionate use of discovery rules “with only faint hope that the discovery process might lead eventually to some plausible cause of action,” targeting of “deep pocket defendants . . . without regard to their actual culpability,” and manipulation of class representatives by plaintiffs’ attorneys.<sup>15</sup> These practices dissuaded qualified persons from serving on corporate boards, chilled corporations’ disclosure of future prospects, and interfered with the raising of capital, thereby harming investors, issuers, and the national economy at large.<sup>16</sup>

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8. *Merrill Lynch v. Dabit*, 547 U.S. 71, 79 (2006). The existence of an implied right of action was proposed in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Penn. 1946), where Judge Kirkpatrick argued that Congress’ failure to expressly deny an individual right of action meant that private individuals were not prevented from bringing suit to enforce the “broad purpose[s]” of the act: the regulation of securities transactions and the “elimination of all manipulative or deceptive practices in such transactions.” The U.S. Supreme Court endorsed this view in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971) (“It is now established that a private right of action is implied under § 10(b).”). See also *J.I. Case Co. v. Borak*, 377 U.S. 426, 430–31 (1964) (recognizing a private right of action for violation of the SEC’s rules governing proxy solicitations).

9. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975) (holding that private civil remedies for money damages from violations of Rule 10b-5 are limited to “purchasers or sellers of securities.”).

10. *Id.* at 740. A primary concern is the cost of discovery, due to the need for extensive depositions of corporate officers and examination of business documents inherent in securities litigation. *Id.* at 741. This “permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an in terrorem increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence . . . .” *Id.*

11. See *id.*

12. *Id.*

13. 15 U.S.C. § 78u-4 (1998).

14. *Merrill Lynch v. Dabit*, 547 U.S. 71, 81 (2006).

15. H.R. CONF. REP. NO. 104-369 (1995).

16. See *id.*; see also *Private Securities Litigation Reform Act—Major Developments and Issues*,

To protect corporations and their personnel from extortionate and frivolous lawsuits, the PSLRA implemented a number of procedural hurdles that apply to private plaintiff class actions brought pursuant to the Federal Rules of Civil Procedure.<sup>17</sup> A large portion of the statute is directed towards regulating the conduct of plaintiffs' attorneys. To protect plaintiffs from manipulation by plaintiffs' counsel, the statute requires a sworn certification by the representative plaintiff.<sup>18</sup> The certification must, *inter alia*, state that the plaintiff has authorized the filing of the complaint, state that the plaintiff did not purchase the security in question at the direction of plaintiffs' counsel, identify the transactions that are the subject of the litigation, identify any class actions filed by the same plaintiff in the previous three years, and state that the plaintiff is not accepting any payment for serving as the class representative beyond the plaintiff's pro rata share of any recovery.<sup>19</sup> Additionally, the PSLRA includes a mandatory analysis of whether the suit is frivolous under Fed. R. Civ. P. 11.<sup>20</sup> Although the PSLRA does not alter Rule 11's standards, it requires the court "upon final adjudication of the action," to "include in the record specific findings" regarding compliance with Rule 11.<sup>21</sup>

The PSLRA also establishes a heightened pleading standard, its "most significant and most heavily litigated provision."<sup>22</sup> This standard exceeds the already heightened standard for pleading fraud or mistake under the Federal Rules<sup>23</sup> by requiring plaintiffs to "specify each statement alleged to have been misleading, and the reason or reasons why the statement is misleading."<sup>24</sup> The plaintiff must state with particularity "facts giving rise to a strong inference that the defendant acted with the required state of mind" with regards to an act or omission.<sup>25</sup> Plaintiffs asserting allegations based on "information or

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27 SEC. LITIG.: FORMS & ANALYSIS § 1:2 (2011) [hereinafter *Major Developments and Issues*].

17. 15 U.S.C. § 78u-4(a)(1) (2010). For the basic requirements governing federal class actions, see FED. R. CIV. P. 23.

18. 15 U.S.C. § 78u-4(a)(2).

19. *Id.* The statute also establishes requirements for selection of lead plaintiffs and plaintiffs' counsel and sets limitations on attorney's fees and recovery by lead plaintiffs.

20. FED. R. CIV. P. 11(b) states that the presentation of pleadings, motions or other papers to the court certifies to the court that pleadings, written motions, briefs and other papers are "not being presented for any improper purpose, such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation."

21. 15 U.S.C. § 78u-4(c)(1).

22. *Major Developments and Issues*, *supra* note 16, § 1:2.

23. FED. R. CIV. P. 9(b) requires a party alleging fraud or mistake to "state with particularity the circumstances constituting fraud or mistake."

24. 15 U.S.C. § 78u-4(b)(1)(B).

25. 15 U.S.C. § 78u-4(b)(2)(A). This is the "scienter" requirement. Scienter is defined as a "mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976). Thus, "[m]erely pleading facts establishing that a defendant had the motive

belief” must “state with particularity all the facts on which that belief is formed.”<sup>26</sup> Finally, plaintiffs must also plead “loss causation” by proving that “the act or omission of the defendant alleged to have violated this chapter caused the loss for which the plaintiff seeks to recover damages.”<sup>27</sup>

To reduce extortionate discovery requests, the PSLRA provides for a stay of discovery pending any motion to dismiss, unless discovery is necessary to preserve evidence or to prevent undue prejudice to a party.<sup>28</sup> This provision protects defendants from the burdens of discovery costs in cases that are potentially groundless (and therefore likely to be dismissed).<sup>29</sup> It also prevents plaintiffs from filing a case without enough information and then using discovery to obtain enough information to avoid dismissal.<sup>30</sup>

Finally, the PSLRA includes a “safe harbor” provision for forward-looking statements. This provision eliminates liability “with respect to any forward-looking statement, whether written or oral, if and to the extent that . . . [the statement] is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.”<sup>31</sup> For a forward-looking statement to be actionable, the plaintiff must prove that the statement was made with actual knowledge that it was false or misleading.<sup>32</sup> Thus, the combination of the safe harbor provision and the higher pleading standard incentivizes plaintiffs with a case based solely on allegedly false forward-looking statements to file in state court instead of federal court.<sup>33</sup>

Accordingly, to avoid the heightened procedural burdens imposed by the PSLRA, plaintiffs began bringing securities class actions in state

and opportunity to commit securities fraud does not establish scienter under the Securities Act.” *Burns v. Prudential Sec., Inc.*, 116 F. Supp. 2d 917, 923 (2000) (internal quotations omitted).

26. 15 U.S.C. § 78u-4(b)(1)(B). To circumvent this requirement, plaintiffs’ counsel would avoid pleading using the words “information and belief” and instead base allegations on “investigation of counsel” to invoke the work product privilege. *Major Developments and Issues*, *supra* note 16, § 1:2. Courts have rejected this tactic because facts are not protected by the work product doctrine. *Id.*

27. 15 U.S.C. § 78u-4(b)(4).

28. *Id.* § 78u-4(b)(3)(B).

29. *Major Developments and Issues*, *supra* note 16, § 1:2

30. *Id.*; *Lapicola v. Alt. Dual Fuels, Inc.*, No. 3-02-CV-0299-G, 2002 WL 531545, at \*1 (N.D. Tex. Apr. 5, 2002) (“There are two primary purposes for the stay of discovery contained in the PSLRA: (1) to prevent the imposition of any unreasonable burden on a defendant before disposition of a motion to dismiss; and (2) to avoid the situation in which a plaintiff sues without possessing the requisite information to meet the heightened pleading requirements of the PSLRA, then uses discovery to acquire that information and resuscitate a complaint that is otherwise subject to dismissal.”).

31. 15 U.S.C. § 78u-5(c)(1)(A)(i) (2012).

32. *Id.* § 78u-5(c)(1)(B)(1).

33. Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 298 (1998).

court under state securities laws.<sup>34</sup> This resulted in a substantial increase in state court securities litigation based on two strategies. In some cases, plaintiffs' counsel would file state law claims if the facts appeared to not satisfy the heightened pleading requirements imposed by the PSLRA.<sup>35</sup> In other cases, plaintiffs' counsel would file claims in both state and federal court simultaneously to avoid the PSLRA's discovery stay provision, allowing plaintiffs to take advantage of state discovery rules while the federal court stayed discovery pending a motion to dismiss.<sup>36</sup> The combination of circumstances leading to an increase in state court litigation after the PSLRA was dubbed the "federal flight loophole."<sup>37</sup>

The shift to state court venues reopened many of the wounds the PSLRA was intended to close, including the effects of such class actions on companies' ability to raise capital.<sup>38</sup> The PSLRA's safe-harbor provisions, intended to encourage companies to provide financial forecasts to investors without fear of litigation, were weakened.<sup>39</sup> The state court shift subjected securities issuers to disparate standards from jurisdiction to jurisdiction—both between federal and state law and between laws of different states.<sup>40</sup> Because publicly traded companies cannot control where their securities are traded after the initial public offering, those companies also lost control over choice of venue—thus, "a single state [could] impose the risks and costs of its peculiar litigation system on all national issuers."<sup>41</sup>

### C. *The Securities Litigation Uniform Standards Act of 1998*

Congress enacted SLUSA<sup>42</sup> to close this loophole and to prevent

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34. *LaSala v. Bordier et Cie*, 519 F.3d 121, 128 (3d Cir. 2008); *Spielman v. Merrill Lynch*, 332 F.3d 116, 123 (2d Cir. 2003) ("Confronted with more onerous procedural requirements and dimmed prospects of success under the PSLRA, litigants simply abandoned use of federal court and filed suit in state court under state securities laws."); S. REP. NO. 105-182, at 3 (1998). A witness at a Senate committee hearing testified that state court securities class actions were "virtually unknown" prior to PSLRA. *Id.* at 4. Some commentators have questioned whether the federal flight problem actually existed to the extent Congress believed. See Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 42-45 (1998). Regardless of the strength of the empirical data on the federal flight phenomenon, the PSLRA's heightened pleading requirements, discovery stay provision, and safe-harbor provision provided an incentive for plaintiffs to file in state court. Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 294-96 (1998).

35. S. REP. NO. 105-182, at 3 (1998).

36. *Id.*

37. See *Spielman*, 332 F.3d at 123.

38. S. REP. 105-182, at 4.

39. *Id.*

40. See *id.* at 3.

41. S. REP. 105-182, at 5.

42. 15 U.S.C. § 78bb (2000).

plaintiffs from evading the PSLRA's burdens by migrating to state court.<sup>43</sup> SLUSA precludes a covered class action if: (1) the class consists of more than fifty members, (2) the claim is not exclusively derivative, (3) the claim is based on state law, and (4) the claim is brought by "any private party alleging a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security."<sup>44</sup> A "covered class action" is defined as a single lawsuit in which damages are sought on behalf of more than fifty persons.<sup>45</sup> A "covered security" is a nationally traded security listed on a regulated national exchange.<sup>46</sup> A plaintiff "may pursue such a [securities fraud] claim either (1) as a federal securities fraud class action, or (2) as a state law individual action," but "may not pursue such a claim as a state law class action."<sup>47</sup>

A state court class action that meets SLUSA's requirements is removable to federal court pending termination of the proceedings.<sup>48</sup> If the plaintiff moves to remand to state court on the basis that the action

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43. *Brown v. Calamos*, 664 F.3d 123, 124 (7th Cir. 2011), *cert. denied*, 132 S.Ct. 2774 (2012).

44. See 15 U.S.C. § 78bb(f)(1); *Brown*, 664 F.3d at 124. Although many cases refer to SLUSA's "preemption" of claims, the Act "does not actually 'preempt' causes of action, so much as it prevents causes of action from being asserted *through the vehicle of a class action lawsuit*." *LaSala v. Bordier et Cie*, 519 F.3d 121, 127 n.2 (3d Cir. 2008) (emphasis added); see also *Merrill Lynch, v. Dabit*, 547 U.S. 71, 72 (2006) ("SLUSA does not pre-empt any cause of action. It simply denies the use of the class-action device to vindicate certain claims."); THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION, § 12.15[2][A], 294 (6th ed. 2009) ("[SLUSA] is not complete in its elimination of state court class actions . . ."); *Romano v. Kazacos*, 609 F.3d 512, 519 (2d Cir. 2010) ("SLUSA is a statute of preclusion, rather than preemption."); *Kircher v. Putnam Funds Trust Co.*, 547 U.S. 633, 636 n.1 ("The preclusion provision is often called a preemption provision; the Act, however, does not itself displace state law with federal law but makes some state law claims nonactionable through the class-action device in federal as well as state court."). Thus, an individual plaintiff or a class of fewer than fifty plaintiffs may bring such claims without problem. See *Dabit*, 547 U.S. at 87. Despite this distinction, the case law rather consistently refers to SLUSA's effect as "preemption." In the interest of consistency with the case law, this Comment will use "preemption" to discuss SLUSA's effect, with the caveat that preclusion is probably the more accurate term according to the above authorities.

45. 15 U.S.C. § 78bb(f)(5)(b).

46. *Dabit*, 547 U.S. at 83; 15 U.S.C. § 78bb(f)(5)(E).

47. *LaSala*, 519 F.3d at 129. See also *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 312 (6th Cir. 2009) (discussing how plaintiff could have filed on behalf of himself and up to forty-eight others, or filed a class action in compliance with the PSLRA). This description of the narrow scope of SLUSA preclusion deserves further explanation. The first option, bringing the suit as a federal securities fraud class action (pursuant to FED. R. CIV. P. 23) would subject the suit to the requirements of the PSLRA, thus bringing it outside SLUSA's loophole-closing rationale. The second option, the state law individual action, would not present the extortive, abusive or manipulative tendencies of class actions that the PSLRA was enacted to remedy in the first place.

48. 15 U.S.C. § 78bb(f)(2); *Atkinson v. Morgan Asset Mgmt., Inc.*, 658 F.3d 549, 552 (6th Cir. 2011). Removal is at the option of the defendant, and in the alternative, "a defendant can elect to leave a case where the plaintiff filed it and trust the state court (an equally competent body) to make the preclusion determination." *Kircher v. Putnam Funds Trust*, 547 U.S. 633, 646 (2006) (internal citations omitted).



does not meet the requirements for preclusion under SLUSA, the motion raises a jurisdictional issue, and neither a federal court nor a state court has jurisdiction over an action precluded under SLUSA.<sup>49</sup> If SLUSA does not preclude the action, the federal court lacks jurisdiction over the merits of the case and must remand it to state court.<sup>50</sup>

In addition to permitting removal, SLUSA grants federal courts the authority to stay discovery in related state court lawsuits.<sup>51</sup> This provision is in response to plaintiffs' attempts to work around the PSLRA's discovery stay by using discovery materials obtained from a related state court action to supplement its factual claims in the federal case.<sup>52</sup> This is especially a concern where the same attorney or attorneys represent both the state and federal plaintiffs.<sup>53</sup> Federal courts considering whether to stay discovery in state court actions ask (1) whether there is a risk of the federal plaintiffs obtaining the state court plaintiffs' discovery, (2) whether the state and federal actions contain overlapping claims and facts, and (3) the burden that the state court discovery would impose on the defendants.<sup>54</sup> This provision gives

49. *Kircher*, 547 U.S. at 643–44; *Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 297–98 (2005) (“The SLUSA removal provision, § 78bb(f)(2), is jurisdictional.”). *Rowinski* describes this removal provision as an exception to the well-pleaded complaint rule via the complete preemption doctrine. For background on the well-pleaded complaint rule, see *Louisville & Nashville R.R. Co. v. Mottley*, 211 U.S. 149, 152 (1908) (holding that the federal courts have federal-question jurisdiction “only when the plaintiff’s statement of his own cause of action shows that it is based upon [federal law or the Constitution]”); *Caterpillar Inc. v. Williams*, 482 U.S. 386, 392 (1987) (“[F]ederal jurisdiction exists only when a federal question is presented on the face of the plaintiff’s properly pleaded complaint.”). The complete preemption doctrine holds that “[o]nce an area of state law has been completely pre-empted, any claim purportedly based on that pre-empted state law is considered, from its inception, a federal claim, and therefore arises under federal law.” *Caterpillar*, 482 U.S. at 393.

50. *Id.* The circuits are split as to whether a remand order under SLUSA is reviewable on appeal. Compare *United Investors Life Ins. Co. v. Waddell & Reed, Inc.*, 360 F.3d 960 (9th Cir. 2004) (SLUSA remand order based on district court’s perceived absence of subject matter jurisdiction not appealable), and *Spielman v. Merrill Lynch*, 332 F.3d 116 (2d Cir. 2002) (same), with *Kircher v. Putnam Funds Trust*, 373 F.3d 847 (7th Cir. 2004) (determining that SLUSA’s preemptive effects mean that a remand decision under SLUSA is not merely jurisdictional and thus is not subject to the general rule against appealability of remand orders). See also generally THOMAS LEE HAZEN, 4 TREATISE ON THE LAW OF SECURITIES REGULATION, § 12.15[2][D], 306 (6th ed. 2009). Generally, a decision to remand is a final appealable order under 28 U.S.C. § 1291, unless the decision is made on jurisdictional grounds. *Id.*

51. 15 U.S.C. 78u-4(b)(3)(D) (2010) (“Upon a proper showing, a court may stay discovery proceedings in any private action in a State court, as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this paragraph.”); see also *Major Developments and Issues*, *supra* note 16, § 1:2.

52. *Major Developments and Issues*, *supra* note 16, § 1:2.

53. See, e.g., *In re DPL Inc.*, 247 F. Supp. 2d 946 (S.D. Ohio 2003) (enjoining state discovery after attorney representing plaintiffs in both federal and state actions indicated that he anticipated sharing discovery obtained in the state court proceeding with the federal plaintiffs).

54. See, e.g., *In re Cardinal Health, Inc.*, 365 F. Supp. 2d 866, 873, 877 (S.D. Ohio 2005) (enjoining state court discovery); *In re Gilead Scis.*, No. C 03-4999 MJJ, 2004 WL 3712008 (N.D. Cal. Nov. 22, 2004) (declining to enjoin state court discovery applying the same factors).

plaintiffs an extra incentive to avoid SLUSA's reach.

The U.S. Supreme Court has adopted a presumption that SLUSA is to be interpreted broadly.<sup>55</sup> In *Merrill Lynch v. Dabit*, the plaintiffs brought a state court action for breach of fiduciary duty and breach of contract.<sup>56</sup> They claimed that due to the defendant corporation's over appraisal of stock values and issuance of misleading research, stockholders held onto their overvalued securities long past the point where they would have sold had they known the true value of the stock.<sup>57</sup> The Second Circuit reversed the District Court's judgment of dismissal, explaining that to the extent that Merrill Lynch's actions led brokers to hold onto their securities rather than purchase or sell securities, the fraudulent conduct was not "in connection with the purchase or sale of" securities, and thus outside SLUSA's preemptive scope.<sup>58</sup> The U.S. Supreme Court reversed. It interpreted the language "in connection with the purchase or sale of a covered security" to mean that "it is enough that the fraud alleged 'coincide' with a securities transaction—whether by the plaintiff or by someone else" for SLUSA to apply.<sup>59</sup> Thus, the statute preempted the plaintiffs' "holder" claims, where the fraud alleged caused investors to hold on to securities as their true value declined—even though by definition no actual purchase or sale of the securities occurred during this period.<sup>60</sup> In reaching this conclusion, the U.S. Supreme Court explained:

The presumption that Congress envisioned a broad construction follows not only from ordinary principles of statutory construction but also from the particular concerns that culminated in SLUSA's enactment. A narrow reading of the statute would undercut the effectiveness of the 1995 Reform Act and thus run contrary to SLUSA's stated purpose.<sup>61</sup>

### III. THE CIRCUIT SPLIT

SLUSA has not completely closed the federal flight loophole<sup>62</sup> left open by the PSLRA. Recently, the circuit courts have been forced to address attempts by plaintiffs to "'plead around' SLUSA by cloaking

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55. See *Merrill Lynch v. Dabit*, 547 U.S. 71, 86–87 (2006).

56. See *id.* at 75.

57. *Id.* The plaintiffs were stockbrokers, employed by Merrill Lynch, who purchased stocks for themselves and for their clients using research disseminated by the company. *Id.* The stockbrokers claimed that Merrill Lynch breached its fiduciary duties by over appraising stock values and issuing misleading research, using its "misinformed brokers" to inflate the prices of clients' stocks. *Id.*

58. *Id.* at 77–78.

59. *Id.* at 85.

60. *Id.* at 86.

61. *Id.*

62. *Spielman v. Merrill Lynch*, 332 F.3d 116, 123 (2d Cir. 2003).

their claims with state law titles.”<sup>63</sup> This problem arises where a plaintiff pleads state law claims such as breach of contract or breach of fiduciary duty, but also alleges misrepresentations or omissions by the defendant, usually in the statement of facts. A court reviewing such a complaint must determine whether the plaintiff has actually pled a securities fraud claim despite labeling it as a state law cause of action, in which case SLUSA prevents the claim from proceeding. This Part analyzes the different methods used by the U.S. courts of appeals to analyze the pleadings and to dispose of cases where SLUSA is deemed to apply.

#### A. The Sixth Circuit’s “Literalist”<sup>64</sup> Approach

The Sixth Circuit interprets SLUSA’s “alleging a misrepresentation or omission” element broadly and literally to determine whether state law claims are barred by SLUSA. In *Segal v. Fifth Third Bank*, the plaintiff brought a class action against Fifth Third Bank. The plaintiff class consisted of beneficiaries of trust, estate, and fiduciary accounts for which the bank acted as a corporate fiduciary.<sup>65</sup> In alleging breach of fiduciary duty, the plaintiff accused Fifth Third of (1) investing assets in proprietary mutual funds rather than superior funds operated by competitors; (2) promising that fiduciary accounts would receive “individualized” management, then breaching that agreement by “providing standardized and largely automated management” by “relatively inexperienced” and “low-level” employees; and (3) investing in too many low-yielding investments in order to cover the accounts’ tax liabilities.<sup>66</sup> After the defendants moved to dismiss on the grounds of SLUSA preclusion, the plaintiffs amended the complaint to remove direct allegations of “misrepresentation,” “omissions,” and “schemes.”<sup>67</sup> The district court granted Fifth Third Bank’s motion to dismiss for failure to state a claim, based on SLUSA.<sup>68</sup>

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63. *Segal v. Fifth Third Bank*, N.A., No. 1:07-cv-348, 2008 WL 819290, at \*3 (S.D. Ohio, Mar. 25, 2008).

64. This term was coined by Judge Posner in *Brown v. Calamos*, 664 F.3d 123, 127 (7th Cir. 2011).

65. *Segal v. Fifth Third Bank*, N.A., 581 F.3d 305, 308 (6th Cir. 2009).

66. *Id.* The state law claims included breach of fiduciary duty, unjust enrichment, and breach of contract, as well as individual claims brought by the class representative. *Segal v. Fifth Third Bank*, N.A., No. 1:07-cv-348, 2008 U.S. Dist. LEXIS 109776, at \*1–2 (S.D. Ohio Mar. 25, 2008). Federal jurisdiction was based on diversity. *Id.* at \*4.

67. *Segal*, 2008 U.S. Dist. LEXIS 109776 at \*8–9.

68. *Segal*, 581 F.3d at 308. The district court stated, “A review of [the amended complaint] leads to the inescapable conclusion that Plaintiffs’ action is premised upon a central factual allegation: that Fifth Third misrepresented or failed to disclose material facts, and/or engaged in a manipulative or deceptive course of conduct . . . .” *Segal*, 2008 U.S. Dist. LEXIS 109776 at \*9.

The Sixth Circuit affirmed dismissal. Agreeing with the district court that the amended complaint alleged “misrepresentations, material omissions and manipulation,” the court was not convinced by the plaintiffs’ disclaimer to the contrary, which stated: “None of the causes of action stated herein are based upon any misrepresentation or failure to disclose material facts to plaintiffs . . . .”<sup>69</sup> In rejecting this disclaimer, the court explained:

Courts may look to—they must look to—the substance of a complaint’s allegations in applying SLUSA. Otherwise, SLUSA enforcement would reduce to a formalistic search through the pages of the complaint for magic words—“untrue statement,” “material omission,” “manipulative or deceptive device”—and nothing more. But a claimant can no more elude SLUSA’s prohibitions by editing out covered words from the complaint than by disclaiming their presence. For the same reason a claimant does not have the broader authority to disclaim the applicability of SLUSA to a complaint, he cannot avoid its application through artful pleading that removes the covered words from the complaint but leaves in the covered concepts.<sup>70</sup>

Under this approach, the court looked to “whether the complaint covers the prohibited theories,” not to whether it uses the “prohibited words.”<sup>71</sup>

The Sixth Circuit also rejected the plaintiffs’ argument that the state law claims did not *depend* on allegations of misrepresentation or omission, and that those allegations were thus not *material*.<sup>72</sup> The court explained that SLUSA does not ask whether the allegations of misrepresentation are “material” to the state law claims, or whether the state law claims are “dependent” on those allegations; “it asks whether the complaint *includes* these types of allegations, pure and simple.”<sup>73</sup>

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69. *Segal*, 581 F.3d at 309–11.

70. *Id.* at 310–11. In addition to looking to the “substance” of the complaint, courts applying the literalist approach may look to external sources to determine the “essence” of the complaint. *See* *Dudek v. Prudential Sec., Inc.*, 295 F.3d 875 (8th Cir. 2002). In *Dudek*, the plaintiffs filed a complaint in New York state court, pleading fraud and deceit, deceptive business practices, and negligent misrepresentation, among others, and alleged that the defendants “affirmatively” misled the plaintiffs into purchasing certain annuities. *Id.* at 879. The plaintiffs voluntarily dismissed the complaint. They then re-filed in Iowa state court, removing the allegations of fraud, misrepresentation and nondisclosure. *Id.* The Eighth Circuit found that the “fact allegations in the two complaints are otherwise essentially the same,” and that the “essence of *both complaints* is [misrepresentation and non-disclosure].” *Id.* at 880 (emphasis added). Thus, “in substance,” the Iowa state court complaint alleged misstatements and omissions in connection with purchase and sale of annuities. *Id.*

71. *Segal*, 581 F.3d at 311.

72. *Id.* (emphasis added).

73. *Id.* (emphasis added).

*B. The Ninth Circuit's "Dismissal Without Prejudice" Approach*

The Ninth Circuit uses an approach similar to that of the Sixth Circuit.<sup>74</sup> However, in *Stoody-Broser v. Bank of America*, the Ninth Circuit endorsed the procedure of dismissing a SLUSA-preempted complaint with leave to amend the complaint, thereby allowing the plaintiff to plead new claims not preempted by SLUSA. In *Stoody-Broser*, the plaintiff class consisted of thousands of trust beneficiaries administered by Bank of America.<sup>75</sup> The plaintiffs alleged that the bank breached its fiduciary duty in the management of the trust accounts by investing in affiliated mutual funds, and that the bank's administration of the accounts was compromised by a conflict of interest.<sup>76</sup> Although the complaint did not explicitly reference misrepresentation or omission of material fact, the district court found that the plaintiffs had "framed the pleading" to avoid SLUSA preemption.<sup>77</sup> Because the essence of the complaint was an allegation that the bank had misrepresented and omitted material facts regarding the bank's conflicts of interest and expenses in managing the funds, the district court dismissed the claim without leave to amend.<sup>78</sup>

The Ninth Circuit affirmed dismissal under SLUSA.<sup>79</sup> It found that the complaint alleged omissions of material fact and deceptive practices in connection with the bank's investment in affiliated mutual funds, and that fraudulent self-dealing was the "essence" of the claims.<sup>80</sup> However, the court determined that the plaintiff should be permitted to amend the complaint.<sup>81</sup> Recognizing the possibility of artful pleading through removal of particular claims or entire words, the court nonetheless believed it possible for the plaintiff to allege a breach of fiduciary duty "so long as the complaint does not allege, either expressly or implicitly, misrepresentations, omissions or fraudulent practices coincidental to the violation."<sup>82</sup>

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74. See *Brown v. Calamos*, 664 F.3d 123, 127–29 (7th Cir. 2011).

75. *Stoody-Broser v. Bank of Am., N.A.*, No. C 08-02705 JSW, 2009 WL 2707393, at \*1 (N.D. Cal. Aug. 25, 2009), *aff'd in part*, 442 Fed. Appx. 247 (9th Cir. 2011).

76. *Stoody-Broser*, 2009 WL 2707393 at \*2–3.

77. *Id.* at \*3.

78. *Id.* at \*5. The district court explained its concern that "mere omission of key terms and references to omissions and fraudulent practices would be merely artful pleading, which would be improper." *Id.*

79. See *Stoody-Broser*, 442 Fed. Appx. at 249.

80. *Id.* at 248. The court cited Ninth Circuit precedent holding that misrepresentation need not be an element of the claim to be precluded. *Proctor v. Vishay Intertechnology Inc.*, 584 F.3d 1208, 1222 n.13 (9th Cir. 2009). See also *Dudek v. Prudential Sec., Inc.*, 295 F.3d 875, 880 (8th Cir. 2002) (referring to "the essence" of the complaint in finding the claims preempted).

81. *Stoody-Broser*, 442 Fed. Appx. at 248.

82. *Id.* at 248–49. See also FED. R. CIV. P. 15(a) ("[A] party may amend its pleading only with

Amendments to the complaint may allow the plaintiff to successfully avoid SLUSA preclusion even where the plaintiff has previously alleged fraud in the complaint. In *Green v. Ameritrade, Inc.*, Ameritrade offered a paid service that allowed subscribers to receive stock quotes in real time.<sup>83</sup> The subscribers brought a class action against Ameritrade, claiming that the service did not actually offer real time information with respect to option quotes, and that subscribers to the service “[made] investment decisions to purchase or sell options based upon stale last sale information.”<sup>84</sup> The complaint alleged state law claims for breach of contract, fraud by intentional misrepresentation, fraud by negligent representation, deceptive trade practices, and violation of the Nebraska Consumer Protection Act.<sup>85</sup> The district court found that the action was preempted by SLUSA, but denied the motion to dismiss and gave the plaintiff thirty days to amend the complaint.<sup>86</sup> The amended complaint removed all references to investors’ reliance on stale information and instead alleged that Ameritrade failed to provide subscribers with the price information it had promised in the subscription contract.<sup>87</sup> The district court found that SLUSA did not preempt the action pled in the amended complaint, and remanded the case to state court.<sup>88</sup>

On appeal, the Eighth Circuit was convinced that the pleaded cause of action did not arise from a sale or purchase of a security in reliance on false information gained from the service.<sup>89</sup> The court explained that

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the opposing party’s written consent or the court’s leave. The Court should freely give leave when justice so requires.”); *Foman v. Davis*, 371 U.S. 178, 182 (1962) (“If the underlying facts or circumstances relied upon by a plaintiff may be a proper subject of relief, he ought to be afforded an opportunity to test his claim on the merits” unless good reason exists for not granting leave).

83. *Green v. Ameritrade, Inc.*, 279 F.3d 590, 593 (8th Cir. 2002).

84. *Id.* at 594.

85. *Id.*

86. *Id.* In the Eighth Circuit, leave to file an amended complaint is at the discretion of the district court. *See Dudek v. Prudential Sec., Inc.*, 295 F.3d 875, 880 (8th Cir. 2002). In *Dudek*, the Eighth Circuit found that the district court did not abuse its discretion in denying leave to file an amended complaint, because the plaintiffs failed to comply with local rules requiring the inclusion of a proposed amended pleading in their brief to the court on the removal and preemption issues, and failed to describe the changes they would make to avoid preemption. *Id.*

87. *Green*, 279 F.3d at 594.

88. *Id.* at 594–95. The original complaint alleged that Ameritrade falsely represented that the service provided real time and last-sale information to subscribers. This reference to false representation was removed from the amended complaint. Instead, the complaint merely alleged that Ameritrade had promised certain information to its subscribers and failed to provide it. *Id.* Thus, by removing the “magic words” of “misrepresentation,” the suit was placed outside the scope of SLUSA. *Cf. Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 310–11 (6th Cir. 2009) (“A claimant can no more elude SLUSA’s prohibitions by editing out covered words from the complaint than by disclaiming their presence.”).

89. *Green*, 279 F.3d at 598. It should be noted that *Green* preceded the U.S. Supreme Court’s holding in *Dabit*, where the Court held that the phrase “in connection with the sale or purchase of a covered security” is to be construed broadly. In *Green*, Ameritrade argued that consumers in general used the type of information provided by the real time quote service in question to purchase or sell

because the amended complaint completely omitted any reference to “purchase or sale” in reliance on that information, the complaint essentially alleged a breach of contract claim and not a securities fraud claim.<sup>90</sup> The court rejected all of Ameritrade’s arguments regarding artful pleading. Ameritrade first argued that the plaintiff had merely “changed [the] label” applied to his claim to “conveniently style[]” it as a breach of contract.<sup>91</sup> The court disagreed, stating that the complaint omitted any reference to a sale or purchase<sup>92</sup> and that his “prayer for relief does not rely on any alleged sale or purchase . . . .”<sup>93</sup> Second, Ameritrade argued that the plaintiff “implicitly plead[ed] a misrepresentation claim” and attempted to avoid federal jurisdiction through artful pleading.<sup>94</sup> The court explained that even if the amended complaint was an attempt at artful pleading, SLUSA could not apply anyway because of the failure to meet the “in connection with” element.<sup>95</sup>

### C. The Third Circuit’s “Factual Predicate” Test

Instead of interpreting SLUSA’s “alleging a misrepresentation or omission” element literally, the Third Circuit takes a more nuanced approach which examines the relationship between the factual allegations and the right to relief. In *LaSala v. Bordier et Cie*, the plaintiffs brought claims against Swiss banks for aiding and abetting a breach of fiduciary duty.<sup>96</sup> The claim alleged that directors and officers

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securities, and that SLUSA therefore barred the suit even though the amended complaint did not suggest reliance on that information in connection with a purchase or sale of securities. *Id.* at 597. The Eighth Circuit held that the plaintiffs were non-sellers and non-purchasers, and therefore SLUSA could not apply. *Id.* at 598; *see also* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 735–36 (1975) (holding that remedies in a § 10b or Rule 10b-5 class action are limited to purchasers or sellers of securities). Based on the broad construction given to “in connection with the sale or purchase of a covered security” in *Dabit*, the Eighth Circuit’s SLUSA analysis may have ended more favorably for Ameritrade. However, having disposed of this argument, the Eighth Circuit analyzes the amended complaint itself, providing a good example of the removal of “magic words” to avoid SLUSA preemption.

90. *Green*, 279 F.3d at 598. The court explained, “[Green] alleges no sale or purchase of a covered security, only that he did not receive the type of information from Ameritrade for which he believed he had contracted and paid twenty dollars monthly.” *Id.*

91. *Id.* at 599.

92. The court appeared to ignore Ameritrade’s argument that the essence of the plaintiff’s securities fraud claim was unchanged even though the label had changed. The court was content to find that the mere omission to a “sale or purchase” was enough to change the complaint entirely. *Id.* at 599.

93. *Id.* This argument appears to be quite similar to the Third Circuit’s “factual predicate” analysis, discussed *infra* Part III(C).

94. *Id.*

95. *Id.* *See supra* note 88, for a discussion of how this case may have ended in a different result had it benefitted from *Dabit*’s broad construction of “in connection with.”

96. 519 F.3d 121, 126 (3d Cir. 2008). The elements of aiding and abetting liability for breach of

of a Delaware corporation had executed a “pump-and-dump” scheme whereby they artificially inflated the corporation’s stock values by misrepresenting the company’s financial situation.<sup>97</sup> The named defendants, Swiss banks, allegedly knowingly assisted the directors in this scheme.<sup>98</sup> The company’s stock price plummeted when the scheme was discovered.<sup>99</sup> The complaint included claims based on Swiss money laundering laws which imposed duties on banks to properly investigate and freeze directors’ money laundering transactions.<sup>100</sup> The defendant banks argued that the plaintiffs’ money laundering claims based on Swiss law were barred by SLUSA because, among other things, the Swiss law claims incorporated the allegations of the state law claims, which were themselves preempted by SLUSA.<sup>101</sup> The district court dismissed all claims, finding them preempted by SLUSA because they all involved substantive allegations of misrepresentation in connection with securities trades.<sup>102</sup>

However, the Third Circuit was not convinced that the state law claims were preempted. It explained that the mere allegation of a misrepresentation does not automatically satisfy SLUSA’s element of a misrepresentation in connection with a securities trade.<sup>103</sup> Rather, the allegation of misrepresentation must be a factual predicate to a claim—meaning that the fact of misrepresentation “gives rise to liability, [and is] not merely an extraneous detail.”<sup>104</sup> It explained: “This distinction [between factual predicates and extraneous details] is important because complaints are often filled with more information than is necessary . . . While it may be unwise . . . to set out extraneous allegations of misrepresentations in a complaint, the inclusion of such extraneous allegations does not operate to require that the complaint

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fiduciary are: (1) breach of fiduciary duty; (2) knowing participation in that breach by the defendant; and (3) damages. *Id.* at 131; *see also* *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001). The court explained that a “pump-and-dump” scheme gives rise to a claim for breach of the duty of loyalty. *LaSala*, 519 F.3d at 130. It also gives rise to a potential claim under federal securities laws for rescission of purchase of stock, or for damages equal to the difference between the purchase price of the security and the actual value. *Id.*

97. *Id.* at 126.

98. *Id.*

99. *Id.*

100. *Id.* at 139.

101. *Id.* at 138–41. According to the complaint, the Swiss money laundering claims required, *inter alia*, a showing that the banks failed to conduct due diligence by verifying the customer’s identity, failed to investigate unusual or suspicious transactions, and failed to freeze assets in accounts with concealed owners. *Id.* at 139. By the Third Circuit’s interpretation, these claims did not depend on a finding of a state law breach of fiduciary duty; however, the Third Circuit left the final interpretation of the law to the district court on remand. *Id.* at 139–42.

102. *Id.* at 141.

103. *Id.*

104. *Id.*



must be dismissed under SLUSA.”<sup>105</sup> Thus, although a plaintiff may not avoid SLUSA simply by arguing that misrepresentation or omission is not an *element* of the claim, the misrepresentation must be “one of a plaintiff’s necessary facts” in order to trigger SLUSA preemption.<sup>106</sup>

The *LaSala* court compared the facts of the case to those of its earlier ruling in *Rowinski v. Salomon Smith Barney, Inc.*, where the plaintiff claimed breach of contract based on the defendant’s dissemination of “biased and materially misleading investment research” in violation of the parties’ services contract.<sup>107</sup> There, the Third Circuit found that the claims were preempted, even though misrepresentation is not an element of breach of contract.<sup>108</sup> The *LaSala* court distinguished by *Rowinski* by explaining that in *Rowinski*, the misrepresentation itself *was* the breach of contract.<sup>109</sup> In other words, the *Rowinski* plaintiffs were required to prove a misrepresentation in order to prevail on their particular breach of contract claim, even though breach of contract generally does not involve an element of fraud. The *LaSala* court explained that “when, as in *Rowinski*, a plaintiff alleges that a misrepresentation made in connection with a securities trade breaches a contract, the plaintiff cannot avoid SLUSA preemption by arguing that misrepresentation is not an element of a breach-of-contract action.”<sup>110</sup>

Having distinguished *Rowinski* and clarified the factual predicate test, the *LaSala* court found that the allegations of misrepresentation in the complaint were “extraneous.”<sup>111</sup> The directors’ alleged misrepresentations discussed in the complaint were not factual predicates to the Swiss money laundering claims because “they have no bearing on whether the Banks’ conduct is actionable . . . .”<sup>112</sup> Instead, the misrepresentations constituted “background details” that the plaintiffs were not required to prove and did not need to allege in the complaint.<sup>113</sup> The Third Circuit found the claims to be outside of SLUSA’s scope, vacated the district court’s order of dismissal, and

105. *Id.* at 141.

106. *Id.*

107. 398 F.3d 294, 299 (3d Cir. 2005).

108. *Id.* at 300.

109. *LaSala*, 519 F.3d at 141. *See also* *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993) (“The failure to carry out a promise made in connection with a securities transaction is normally a breach of contract. It does not constitute fraud unless, when the promise was made, the defendant secretly intended not to perform or knew that he could not perform.”).

110. *LaSala*, 519 F.3d at 141. The Sixth Circuit in *Segal* argued that this explanation is dicta and that *LaSala* and *Rowinski* are actually in direct conflict. *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 311 (6th Cir. 2009). *But see* *Brown v. Calamos*, 664 F.3d 123, 127 (7th Cir. 2011) (explaining that *LaSala* does not contradict *Rowinski*).

111. *LaSala*, 519 F.3d at 141.

112. *Id.*

113. *Id.*

remanded for further proceedings.<sup>114</sup>

#### IV. DISCUSSION

As demonstrated by these cases, both the facts stated in the complaint and the words used to describe them are largely dispositive of SLUSA preemption when SLUSA's "misrepresentation or omission" element is at issue. The disparate standards used by the circuit courts to analyze pleadings under SLUSA have the potential to create a forum-shopping problem for state law securities class actions. Such forum shopping would undermine SLUSA's objectives—namely, ending the federal flight loophole—and thus ultimately allow plaintiffs to avoid the strict requirements of the PSLRA. To ensure that SLUSA is applied uniformly to preempt covered class actions, the federal courts have an interest in arriving at a uniform standard for analyzing securities class action complaints.

The three approaches described in Part III—the Sixth Circuit's literalist approach, the Ninth Circuit's dismissal-without-prejudice approach, and the Third Circuit's factual predicate test—must obviously be analyzed in light of their effectiveness in achieving SLUSA's objectives of closing the federal flight loophole. However, the Courts of Appeals must also keep in mind the important role that private securities litigation serves—allowing private citizens a role in pursuing corporate accountability and seeking appropriate remedies for private harms caused by violation of the federal securities regulations. These competing objectives must be properly balanced in arriving at the ideal standard for analyzing securities class action complaints.

The Third Circuit's factual predicate test strikes an appropriate balance between preemption of state law based securities class actions according to congressional intent, and permitting some state law based claims to avoid removal and dismissal if the claims do not involve fraud. The test is a more nuanced way to determine the true nature of the suit and whether it is by nature a "securities fraud" class action. By asking whether factual assertions form the actual basis for liability in the complaint, or whether the assertions are mere "extraneous detail," the factual predicate test provides an appropriate means for determining whether a state law cause of action is really a fraud claim in disguise. By permitting some extraneous details of misrepresentation or omission, the factual predicate test allows the plaintiff more flexibility in telling its own story through assertions of fact in the pleadings. In addition, by separating factual predicates from extraneous details, the approach

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114. *Id.* at 143.

cautions a court against reading misrepresentations or omissions into the pleadings that do not actually exist or which are not essential to the case.<sup>115</sup>

The factual predicate test does not risk preempting state law causes of action, such as breach of contract or breach of fiduciary duty, that do not seek relief based on a misrepresentation or omission. This is consistent with the longstanding rule that Congress must expressly state its intent to eliminate state law causes of action in order for preemption to apply.<sup>116</sup> Rather than “bring within the ambit of [Rule 10b-5] all breaches of fiduciary duty in connection with a securities transaction,”<sup>117</sup> the test is consistent with the lack of clear congressional intent to preempt state law claims that do not involve manipulation or deception. Under the test, claims that are “in reality no more than ordinary state breach-of-contract claims—actions that lie outside the Act’s basic objectives”<sup>118</sup> will be allowed to continue in state court, and true securities fraud claims—those that rely on proof of a misrepresentation or omission—will be screened out for dismissal in accordance with the objectives of SLUSA. Because SLUSA was intended to preclude securities fraud *class actions* from being litigated in state court, it necessarily follows that what it prevents must be securities fraud claims, *not* breach of contract or breach of fiduciary duty claims.<sup>119</sup>

In contrast, the Sixth Circuit’s literal focus on “allegations” sweeps too broadly. As the Seventh Circuit noted in *Brown v. Calamos*:

*everything* in a complaint (except the request for relief) is an allegation in the sense that it is an assertion that has not been verified [by

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115. See, e.g., *Stephens v. Gentilello*, 853 F. Supp. 2d 462, 468 (D.N.J. 2012). In *Stephens*, defense counsel asked class members in depositions whether it was their contention that the defendant had intentionally lied to them. *Id.* at 368–71. The defendant used the plaintiffs’ answers to these questions to argue that the claims were grounded in fraud and were thus barred by SLUSA. *Id.* The trial court found that any statements by the deponents regarding misrepresentations were “the sort of background details that need to have been alleged, and need not be proved” in the suit for breach of contract, negligence, unjust enrichment, and violations of the New Jersey Consumer Fraud Act, and thus those statements could not provide the basis for SLUSA removal. *Id.* See also *Breakaway Solutions, Inc. v. Morgan Stanley & Co. Inc.*, No. 19522, 2004 WL 1949300, at \*8 (Del. Ch. Aug. 27, 2004) (finding that defendants’ arguments regarding SLUSA preemption read facts into the complaint that were not present).

116. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (“Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.”).

117. *Id.* at 472.

118. *Wharf Ltd. v. United Int’l Holdings, Inc.*, 532 U.S. 588, 596 (2001).

119. See *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980) (“[T]he 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit. Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”) (internal quotations and citations omitted).

litigation] . . . [y]et many of these assertions are not allegations in the sense of charges of misconduct for which the plaintiff is seeking relief. If an allegation of fraud is included as background and unlikely to become an issue in the litigation, why should it doom the suit?<sup>120</sup>

An excessively broad construction of SLUSA has the potential consequence of preempting certain causes of action that the statute was never intended to cover. Because SLUSA was enacted in response to the “federal flight” problem, it follows that SLUSA should not preclude state law causes of action with a low risk of federal flight.<sup>121</sup> A variety of state law claims involving wrongdoing other than fraud in connection with securities transactions are not generally the subject of extortionate “strike suits,” including breach of contract, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty, unjust enrichment, and indemnification.<sup>122</sup> However, the stricter literalist approach to analyzing the pleadings may inadvertently cause such claims to be preempted, *regardless* of whether the state law cause of action is being used as a vehicle for asserting a fraud claim in disguise. Under the literalist approach, *any* allegation—whether explicit or implicit—that a corporation’s directors or agents omitted or misrepresented a fact within the complaint could have the unintended effect of preempting a breach of contract claim if such claim occurs within the same complaint. The Sixth Circuit’s analysis therefore does not distinguish extraneous details included for “storytelling” purpose from those details that actually matter in forming the basis for the plaintiff’s requested relief.

In spite of *Dabit*’s presumption that Congress intended for a broad construction of SLUSA,<sup>123</sup> it is also clear that Congress did not intend to destroy all state law causes of action against corporations. By

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120. 664 F.3d 123, 128 (7th Cir. 2011), *cert. denied*, 132 S.Ct. 2774 (2012). The Seventh Circuit adopted an approach that falls somewhere between the literalist approach of the Sixth Circuit and the factual predicate test of the Third Circuit. The Seventh Circuit’s approach holds that the “suit is barred by SLUSA only if the allegations of the complaint make it likely that an issue of fraud will arise in the course of litigation.” *Id.* at 128–29. Thus, in *Brown*, the suit was barred where a fraud allegation would have been “difficult and maybe impossible to disentangle from the charge of breach of the duty of loyalty that the defendants owed their investors.” *Id.* at 129. *See also* *Jorling v. Anthem, Inc.*, 836 F. Supp. 2d 821, 835 (S.D. Ind. 2011) (recognizing the circuit split over review of claims for SLUSA preemption and describing the Seventh Circuit’s approach as a “hybrid” standard).

121. *See Dabit v. Merrill Lynch*, 395 F.3d 25, 47 (2d Cir. 2003) (“SLUSA’s language and legislative history indicate no intent to preempt categories of state action that do not represent ‘federal flight’ litigation.”), *rev’d on other grounds*, *Merrill Lynch v. Dabit*, 547 U.S. 71 (2006).

122. *See, e.g.,* *Xpedior Creditor Trust v. Credit Suisse First Boston, Inc.*, 341 F. Supp. 2d 258 (S.D.N.Y. 2004) (breach of contract and fiduciary duty claims in connection with initial public offering not preempted); *Breakaway Solutions Inc. v. Morgan Stanley & Co.*, No. 19522, 2004 WL 1949300 (Del. Ch. Oct. 31, 2004) (breach of contract, breach of the implied covenant of good faith and fair dealing, breach of fiduciary duty, unjust enrichment, and indemnification not preempted by SLUSA).

123. *Dabit*, 547 U.S. at 85.

incorporating existing language from Section 10(b) of the 1934 Act<sup>124</sup> and Rule 10b-5,<sup>125</sup> SLUSA “employs terms with settled meaning under existing federal securities law” and “furthers the uniform application of federal fraud standards without expanding or constricting the substantive reach of federal securities regulation.”<sup>126</sup> The Supreme Court has explained that not all breaches of fiduciary duty in connection with a securities transaction are within the reach of § 10(b) and Rule 10b-5; rather, only those breaches that involve fraudulent activity may be actionable under those rules.<sup>127</sup> Reading those rules to include breaches of fiduciary duty not involving fraud “would bring within [Rule 10b-5] a wide variety of corporate conduct traditionally left to state regulation” and would “federalize the substantial portion of the law of corporations” dealing with securities transactions, in the absence of clear congressional intent to do so.<sup>128</sup> Thus, every Rule 10b-5 claim must actually involve “a deceptive device or fraud” to avoid “transform[ing] every breach of fiduciary duty into a federal securities violation.”<sup>129</sup>

Yet, under the Sixth Circuit’s literalist approach, any reference in the complaint to a misrepresentation or omission would prevent a plaintiff from bringing a breach of fiduciary duty claim as a class action in state court, regardless of whether the misrepresentation or omission has any relationship to the breach of fiduciary duty claim. In other words, a plaintiff class could never state “the directors failed to inform us of *X*” and in the same suit say “the directors breached their fiduciary duty on grounds completely unrelated to the failure to inform us of *X*.” Such a result imputes a broader interpretation of “alleges a misrepresentation or omission” to Rule 10b-5 than was intended. Because SLUSA incorporates case law interpreting Section 10(b) and Rule 10b-5’s language regarding representations or omissions,<sup>130</sup> the Sixth Circuit’s

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124. 15 U.S.C. § 78j(b) (2010).

125. 17 C.F.R. § 240.10b-5 (2006) (“It shall be unlawful . . . (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . .”).

126. *Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 299 (3d Cir. 2005). *See also Dabit*, 547 U.S. at 85 (explaining that Congress “imported” language from § 10(b) and Rule 10b-5 into SLUSA’s core provision and thus probably intended for U.S. Supreme Court precedent interpreting the language in those rules to govern the interpretation of analogous language in SLUSA).

127. *Santa Fe Indus., Inc., v. Green*, 430 U.S. 462, 472–73 (1997).

128. *Id.* at 463–64.

129. *S.E.C. v. Zandford*, 535 U.S. 813, 825 n.4 (2002).

130. *See Rowinski*, 398 F.3d at 299 (“Because SLUSA employs terms with settled meaning under existing federal securities law, Congress evidently intended to preempt those actions sufficiently ‘connected’ to a securities transaction to be actionable under § 10(b) and Rule 10b-5.”); *NRLB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981) (“Where Congress uses terms that have accumulated settled meaning . . . a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning.”).

literalist approach would extend SLUSA's preemptive scope from the realm of securities transactions to reach ordinary breaches of fiduciary duty that were not the subject of strike suits, a result not within the contemplation of Congress in enacting the PSLRA and SLUSA.

Furthermore, if a court finds that the allegation of misrepresentation or omission in the complaint precludes a particular claim, it is not clear what should happen to other claims within the same complaint. The circuits are split as to whether SLUSA preempts individual claims or entire actions.<sup>131</sup> If the Sixth Circuit's literalist approach is used in a circuit that also interprets SLUSA to preempt the entire action rather than just the claim, enormous problems could arise. As one court explained, "it does not make sense that Congress would intend to bar legitimate claims simply because they are brought under the umbrella of a lawsuit containing some SLUSA-preempted state law claims."<sup>132</sup> However, that is the result commanded by the literalist approach. By ignoring whether misrepresentations or omissions actually form the factual predicate for liability for each individual claim, and instead focusing on whether the complaint "*includes* these types of allegations, pure and simple . . .,"<sup>133</sup> this approach would tend to preclude a wide range of state law claims, or in extreme cases, preempt every claim in the complaint. This is especially likely after *Dabit's* pronouncement that the "in connection with [purchase or sale of securities]" element is to be interpreted broadly, covering those allegations of fraud that merely "coincide" with a securities transaction.<sup>134</sup> Thus, a plaintiff seeking to join multiple state law claims against an issuer in a circuit that recognizes preemption of entire actions rather than individual claims must avoid any minor mention of facts resembling misrepresentation or omission.<sup>135</sup> Furthermore, plaintiffs might be tempted to avoid this

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131. *Atkinson v. Morgan Asset Mgmt., Inc.*, 664 F. Supp. 2d 898, 905 (6th Cir. 2009) (recognizing a split of authority as to "whether a district court may sever claims that do not allege misrepresentation or must dismiss the action as a whole."); *Proctor v. Vishay Intertechnology Inc.*, 584 F.3d 1208, 1227 (9th Cir. 2009) ("SLUSA does not require the dismissal of non-precluded claims along with precluded claims."); *Dabit v. Merrill Lynch*, 395 F.3d 25, 47 (2d Cir. 2003), *rev'd on other grounds*, 547 U.S. 71 (2006) (remanding SLUSA-preempted claims for dismissal without prejudice and reversing dismissal of non-preempted claims); *In re Lord Abbett Mutual Funds Fee Litig.*, 553 F.3d 248, 255–56 (3d Cir. 2009).

132. *Crimi v. Barnholt*, No. C-08-02249 CRB, 2008 WL 4287566, at \*5 (N.D. Cal. Sept. 17, 2008).

133. *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 311 (6th Cir. 2009) (emphasis added).

134. *Dabit*, 547 U.S. at 85.

135. Consider, for example, a breach of fiduciary duty claim in which the plaintiff class alleges a breach of the directors' duty of loyalty, based on a director's conflict of interest where the director failed to inform others of such conflict. In addition to those claims, the complaint raises a totally separate claim alleging that because of some other unrelated misconduct by the board of directors, the shareholder class members were wrongfully induced into holding onto their shares instead of selling them. Because the complaint would necessarily include both a securities transaction and a statement to

result by splitting claims between multiple lawsuits—with one complaint alleging extraneous details of misrepresentation or omission as background and the other complaint avoiding all mention of those facts.<sup>136</sup> Such an attempt to split claims between state and federal court in order to avoid preemption of purely state law claims would present a problem of parallel litigation that the PSLRA intended to eliminate in the first place.<sup>137</sup> Ultimately, a finding that SLUSA preempts entire actions simply because the complaint alleges “extraneous details” of fraud would expand SLUSA’s reach beyond a desirable scope—to preempt causes of action that are not by their nature *securities fraud* claims. Although preemption of entire actions may deter plaintiffs’ attorneys from testing the boundaries of SLUSA’s preemption of state law claims, there is no evidence that Congress intended such a punitive effect.<sup>138</sup>

While the literalist approach goes too far in preempting claims, the Ninth Circuit’s approach swings too far in the opposite direction. By letting plaintiffs amend the pleadings following a dismissal without prejudice, this approach allows a plaintiff’s case to proceed even after the plaintiff has expressed a clear intent to introduce allegations of fraud into the lawsuit.

On purely procedural grounds, the Ninth Circuit’s approach is highly problematic. Although some authority suggests that allowing the

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the effect of, “Director *X* failed to inform the company of his conflict of interest,” the state law breach of the fiduciary duty of loyalty would be preempted by SLUSA in a jurisdiction that considers SLUSA to bar entire actions rather than individual claims. *See, e.g.,* *Brown v. Calamos*, 664 F.3d 123, 127 (7th Cir. 2011) (explaining that a misleading omission is implicitly alleged by an assertion that an issuer failed to disclose a conflict of interest that would have affected potential investors’ decision to invest in certain funds). The success or failure of a breach of the duty of loyalty does not—and cannot—revolve around whether the defendant failed to disclose a conflict of interest because “that duty is not dissolved by disclosure,” and because “no sane investor would knowingly put himself at the mercy of a disloyal investment manager” anyways. *Id.* at 129; accord RESTATEMENT (FIRST) OF AGENCY § 390 cmt. C (1933) (The fact that the agent discloses that he is acting as an adverse party “does not relieve him from the duty of giving the principal impartial advice based upon a carefully formed judgment as to the principal’s interests.”). Thus, although an allegation that a director failed to disclose a conflict of interest would not have any bearing on a breach of duty of loyalty claim, it would still operate to bring the claim within the scope of SLUSA.

136. *In re* Lord Abbett Mutual Funds Fee Litig., 553 F.3d 248, 255 (3d Cir 2009). In *Lord Abbett*, the Third Circuit even suggested that plaintiffs could split claims amongst multiple actions to allow claims clearly outside the scope of SLUSA to go through and to lump potentially preempted state law claims together in a separate action. *Id.* Although it is unclear how such procedural maneuvering would not violate basic principles of *res judicata*, it is more than likely that neither Congress nor the U.S. Supreme Court in *Dabit* intended to endorse “claim splitting,” either directly or indirectly, by intending a broad construction of SLUSA.

137. *See Dabit*, 547 U.S. at 86–87 (explaining that the prospect of parallel class actions proceeding in state court and federal court “squarely conflicts with the congressional preference for national standards for securities class action lawsuits involving nationally traded securities”) (internal quotations omitted).

138. *Lord Abbett*, 553 F.3d at 255.

plaintiff to amend the complaint is proper when it is possible for the plaintiff to assert a claim outside SLUSA's preemptive scope,<sup>139</sup> the approach may violate the forum manipulation rule.<sup>140</sup> This rule states that where a case has been removed to federal court, the plaintiff may not seek remand by eliminating the factual prerequisites for federal subject matter jurisdiction by amending the complaint.<sup>141</sup> Some circuit courts that have recognized a right to amend the complaint to avoid SLUSA preemption do not address the forum manipulation rule in this context. In *U.S. Mortgage v. Saxton*, the Ninth Circuit justified this approach by pointing out “the inequity of dismissing otherwise valid and viable state law claims on the ground that plaintiff pled—perhaps inadvertently—a cause of action that may be construed as federal in nature.”<sup>142</sup> Recognizing that SLUSA includes no express prohibition against amendment and that the case law was silent on the issue, the grant or denial of leave to amend claims preempted by SLUSA are properly left to the discretion of the district courts.<sup>143</sup> However, some circuits have held that where a district court has subject matter jurisdiction at the time of removal, subsequent acts do not defeat jurisdiction.<sup>144</sup>

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139. FED. R. CIV. P. 15; *Foman v. Davis*, 371 U.S. 178, 182 (1962) (“If the underlying facts or circumstances relied upon by a plaintiff may be a proper subject of relief, he ought to be afforded an opportunity to test his claim on the merits” unless good reason exists for not granting leave.).

140. *Brown*, 664 F.3d at 131.

141. The forum manipulation rule was recognized in *St. Paul Mercury Indem. Co. v. Red Cab Co.*, 303 U.S. 283 (1938) (holding that remand to state court was improper when plaintiff amended the complaint to claim damages below the jurisdictional amount). See also *Rockwell Int'l Corp. v. United States*, 549 U.S. 457, 474 n.6 (“When a defendant removes a case to federal court based on the presence of a federal claim, an amendment eliminating the original basis for federal jurisdiction generally does not defeat jurisdiction.”). But see *Carnegie–Mellon Univ. v. Cohill*, 484 U.S. 343, 356 n.12 (1988) (explaining that *St. Paul* should not be read to require that forum manipulation concerns necessitate a blanket prohibition on remands when federal jurisdiction is inherently discretionary).

142. 494 F.3d 833, 843 (9th Cir. 2007).

143. *Id.*

144. See *Behlen v. Merrill Lynch*, 311 F.3d 1087, 1094 (11th Cir. 2011) (affirming district court's denial of motion to remand after plaintiff amended complaint to delete claims and allegations that might be deemed to fall within the scope of SLUSA); *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, 159 F.3d 1209, 1213 (9th Cir. 1998) (finding that the amended complaint in a securities class action could not support remand because “jurisdiction must be analyzed on the basis of the pleadings filed at the time of removal without reference to subsequent amendments,” and thus “a plaintiff cannot compel remand by amending a complaint to eliminate the federal question upon which removal was based.”); *Freeport–McMoran, Inc. v. KN Energy, Inc.*, 498 U.S. 426, 428 (1991); *Doddy v. Oxy USA, Inc.*, 101 F.3d 448, 456 n.4 (5th Cir. 1996) (“[C]hanges after removal cannot eliminate jurisdiction and require remand.”); *Van Meter v. State Farm Fire & Cas. Co.*, 1 F.3d 445, 450 (6th Cir. 1993) (“[I]f a district court determines subject matter jurisdiction to have existed at the time of removal, yet remands for alleged lack of subject matter jurisdiction based on some post-removal event(s),” the remand order does not arise under 28 U.S.C. 1447(c) and is only reviewable upon a writ of mandamus.). 28 U.S.C. § 1447(c) (2011) states, “If at any time before final judgment it appears that the district court lacks subject matter jurisdiction, the case shall be remanded.” This provision refers to subject matter jurisdiction as it exists at the time of removal. *Van Meter*, 1 F.3d at 450. In light of the foregoing



The Ninth Circuit's approach would allow plaintiffs to remove references to misrepresentation or omission in order to obtain a remand to state court, where they may attempt to reintroduce them.<sup>145</sup> From the outset, the plaintiff's attorney seeks to adduce enough facts to not only plead a proper claim, but also to paint a persuasive picture of corporate wrongdoing as well. In his critique of the Ninth Circuit's approach, Judge Posner explained, "[the plaintiff] must have thought the allegations [of fraud] added *something* to his case, as why else had he made them?"<sup>146</sup> This approach naively disregards the possible motivation for plaintiffs' attorneys, having had their case remanded to state court after amending the complaint, to continue to present a case of securities fraud despite not having formally brought one in the pleadings.<sup>147</sup> Thus, like the Sixth Circuit's literalist approach, the Ninth Circuit's overly formalistic concept of what it means to plead a securities fraud case creates an easy out for plaintiffs' attorneys who wish to present a case of fraud—or at least facts suggesting fraud—in state court.

In addition, the Ninth Circuit's approach imposes no standards of accountability and may reduce the act of pleading to a chaotic trial and error process. *Stoody-Brosier* did not explain whether a plaintiff may amend the complaint multiple times until properly pleading a claim that can avoid SLUSA preemption, or whether a plaintiff only gets one shot at amendments. Given the risk of further delays caused by amending and re-filing the complaint, as well as the increased costs of prolonged litigation, allowing a plaintiffs' attorney a second chance—or third, or fourth, and so on—to amend the complaint until all SLUSA-preempted allegations are effectively removed would undermine one of the main policy rationales of the PSLRA, namely reducing the extortionate effect of securities litigation whereby corporations were encouraged to settle out to avoid the costs and hassle of costly and protracted litigation of

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authority, it is not clear that allowing the plaintiff to amend the complaint to remove allegations of misrepresentation or omission would have the legal effect of depriving the federal court of subject matter jurisdiction, if such jurisdiction existed before the amended complaint.

145. *Brown*, 664 F.3d at 128.

146. *Id.* Judge Posner's "hybrid" standard for reviewing claims for SLUSA preemption addresses the likelihood that allegations of fraud will become an issue at trial. *See supra* note 125.

147. Even in a case that has properly avoided SLUSA preemption and remained in state court, a plaintiff's attorney may be tempted to present allegations of misrepresentation or omission as a matter of trial strategy. *See* Allan Kanner & Tibor L. Nagy, *Legal Strategy, Storytelling and Complex Litigation*, 30 AM. J. TRIAL ADVOC. 1, 11–12 (2006) ("Complex litigation typically involves highly intricate legal and scientific issues . . . . [T]o successfully press the human appeal of her client's claims, the [lawyer] presents her cases through the framework of a story. Her stories are infused with concrete facts, they appeal to emotion and common sense, and they appear at all stages of her cases, presenting themselves in her complaint and emerging as *persistent themes in all of her arguments* and briefs.") (emphasis added).

what tended to be baseless claims of securities fraud. Because “a lawyer who files a securities suit and should know about SLUSA and ought to be able to [avoid pleading fraud],”<sup>148</sup> dismissal without prejudice provides too easy of a way out.

Ultimately, the Ninth Circuit’s intermediate approach is incapable of closing the federal flight loophole. It provides far too much leeway for plaintiffs’ attorneys to assert claims of misrepresentation or omission—thereby essentially pleading a federal claim, according to SLUSA—in state court, and then to simply remove those allegations in the event that the federal district court finds those claims to be preempted once the case is removed. Allowing plaintiffs’ attorneys to test the waters like this would greatly undermine SLUSA’s objectives.<sup>149</sup>

Despite the shortcomings of the Ninth Circuit’s approach, it helps to show the need for a resolution of the circuit split. If the standard for analyzing complaints with allegations of fraud were clear, plaintiffs who pleaded incorrectly and fell into SLUSA’s trap would have a less sympathetic case for seeking leave to amend. A clearer standard for analyzing the pleadings would place plaintiffs’ attorneys on notice and encourage them to draft the complaint carefully to avoid preemption.

## V. CONCLUSION

SLUSA was enacted to prevent circumvention of the PSLRA, making federal courts “the exclusive venue for most securities class action lawsuits.”<sup>150</sup> The development of a circuit split regarding the appropriate scope of SLUSA preemption undermines the uniform standards that the PSLRA and SLUSA were intended to achieve. It is essential that the federal courts resolve this circuit split so that defendants are not subjected to the varying laws of multiple states when sued for securities fraud, and so that plaintiffs can know with more certainty exactly where the limits of federal preemption lie when they plead facts suggesting a misrepresentation or omission in a suit brought under state law causes of action.

But in their differing approaches to determining what exactly constitutes a “fraud” case, the circuit courts have fallen into two traps. On one hand, the Sixth Circuit’s approach results in preemption of state law causes of action even when the plaintiff has not used state law “labels” to disguise the true nature of what is essentially a securities fraud claim. On the other hand, the Ninth Circuit’s approach ignores the

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148. *Brown*, 664 F.3d at 128.

149. *See id.* (“A lawyer who files a securities suit should know about SLUSA and ought to be able to control the impulse to embellish his securities suit with a charge of fraud.”).

150. H.R. REP. NO. 105-640, at 8 (1998).

risk of artful pleading and forum manipulation, and undermines SLUSA's loophole-closing objectives by allowing plaintiffs a second chance after having pled claims that are clearly within SLUSA's preemptive scope. The Third Circuit's factual predicate test strikes an appropriate balance between these two extremes. By determining whether allegations of misrepresentation or omission form the factual predicate for liability under the causes of action asserted by the plaintiff, the Third Circuit discerns between mere "extraneous details" and facts that actually convert the nature of the suit from a basic state law claim to a securities fraud claim. This more nuanced approach to dealing with plaintiffs' attempts to work around SLUSA is best suited to achieve SLUSA's objectives, federal courts who seek to resolve the circuit split are advised to take the middle path and adopt the Third Circuit's factual predicate test.