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# Don't Throw the Baby Out With the Bath Water: The Merits of the Intermediate Approach to the Securities Litigation Uniform Standards Act

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## COMMENT

# Don't Throw the Baby Out with the Bath Water: The Merits of the Intermediate Approach to the Securities Litigation Uniform Standards Act

### *I. Introduction*

In the field of securities litigation, Congress and the courts have uniquely united in their restraint of class actions under the securities laws.[1] In 1995, Congress took action to curb perceived abuses of the securities fraud class-action device by passing the Private Securities Litigation Reform Act (Reform Act) over presidential veto.[2] The Reform Act severely restricts securities fraud plaintiffs' ability to survive a motion to dismiss by simultaneously heightening the pleading requirements and cutting off access to discovery while such a motion is pending.[3] Following its passage, state courts saw a dramatic increase in securities fraud litigation as plaintiffs shifted their forum to pursue claims that could not meet the Reform Act's newly heightened requirements.[4] Thus, in an effort to ensure that all securities fraud class actions complied with the heightened requirements of the Reform Act, Congress passed the Securities Litigation Uniform Standards Act of 1998 (Uniform Standards Act).[5]

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1. Michael A. Collora & David M. Osborne, *Class-Action Reforms Spur Derivative Claims; Shareholders Are Taking a Fresh Look at Derivative Suits to Pursue Investor Fraud Cases*, NAT'L L.J., Feb. 15, 1999, at B8 ("The 1990s have been marked by a series of judicial and legislative efforts to curb securities class actions."); *see also* Scott Dodson, *Squeezing Class Actions*, SUP. CT. OF THE U.S. BLOG (Aug. 30, 2011, 3:35pm), http://www.scotusblog.com/2011/08/squeezing-class-actions ("The Supreme Court's 2010 Term in particular evinces both skepticism of and hostility to class actions [and] . . . the assault on class actions is coming so forcefully from all sides.").

2. John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 335 (1996).

3. Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1015-18 (1996).

4. *Ten Things We Know and Ten Things We Don't Know About the Private Securities Litigation Reform Act of 1995: Joint Written Testimony Before the Subcomm. on Sec. of the Comm. on Banking, Hous. & Urban Affairs*, 105th Cong., Part I(2) (1997) [hereinafter *Ten Things We Know*], *available at* http://securities.stanford.edu/research/articles/19970723sen1.html (statement of Joseph A. Grundfest & Michael A. Perino).

5. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 [hereinafter Uniform Standards Act] (codified in scattered subsections of 15 U.S.C. §§ 77, 78, 80 (2012)).

Broadly speaking, the Uniform Standards Act prevents class-action plaintiffs from bringing state-law securities fraud claims, instead forcing such plaintiffs to use federal laws in federal court and comply with the Reform Act.[6] If defendants assert the applicability of the Uniform Standards Act to a state court action, the case is removed to federal court to determine whether the claim is in fact precluded by the Uniform Standards Act.[7]

Unfortunately, the Supreme Court has not yet addressed at what point fraud allegations are sufficient to merit dismissal. As a result, the circuits have developed three different approaches to measure complaints alleging fraud or misrepresentation in connection with the purchase or sale of a security.[8] In *Brown v. Calamos*, the Seventh Circuit provided a comprehensive critique of the circuit split as well as useful labels for each of the approaches: the *La Sala* Approach, Literalist Approach, and Intermediate Approach.[9] Ultimately, the *Brown* court rejected the very approach this Comment recommends, the Intermediate Approach, which applies a strict meaning to the language of the statute but still permits dismissal without prejudice.[10] As such, the *Brown* decision provides an excellent framework through which to discuss the shortcomings and strengths of the Intermediate Approach as compared to the other approaches.

This Comment focuses on how courts should determine the threshold at which claims allege fraud and misrepresentation in the context of the Uniform Standards Act and the proper disposal of the claims that do. Part II reviews the evolution of the role of securities litigation and class actions in securities regulation, from their inception through the sweeping reforms of the 1990s. Part III presents the judicial interpretations of the Uniform Standards Act that bear on determining when claims allege fraud or misrepresentation. Part IV offers arguments for adopting the Intermediate Approach and uses the Seventh Circuit's opinion in *Brown* as a vehicle for

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6. *See* 15 U.S.C. § 78bb(f)(1) (2012) (amending the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78pp (2012)) ("No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging – (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security."); *see also* 15 U.S.C. § 77p(b)(1) (amending in essentially identical language the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2012)).

7. 15 U.S.C. § 77p(c).

8. Brown v. Calamos, 664 F.3d 123, 127 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).

9. *Id.* at 127, 131.

10. *Id.*

showing why the courts should apply a broad meaning of the Uniform Standards Act but not foreclose the possibility of dismissing these claims without prejudice.

### *II. Evolution of the Role of Securities Litigation: From a Policing Mechanism to a Perceived Corporate Menace*

The benefits of general private rights of action in federal securities legislation have historically been touted as two-fold.[11] First, the private right of action provides damages to the victim of the wrong.[12] Second, the threat of financial liability for failure to comply with the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) should incentivize those potentially liable to take care when managing securities and disclosures.[13] Many view the latter as particularly important given the "limited resources for oversight and enforcement" of the Securities and Exchange Commission (SEC).[14] Still, critics doubt the true value of these benefits in light of their costs, particularly when the class-action device is used.[15]

In the last two decades, controversy has surrounded the lauded value of securities litigation as a mechanism for making injured investors whole and promoting compliance with securities regulation.[16] Many experts in the field have suggested that the securities market itself is the best tool for making investors whole again, particularly if investors diversify their portfolios.[17]

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11. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 745 (6th ed. 2009).

12. *Id.*

13. *Id.*

14. *Id.*

15. *See, e.g.*, Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 333 ("Many critics argue that private securities litigation fails effectively either to deter corporate misconduct or to compensate defrauded investors.").

16. *See, e.g.*, Michael J. Kaufman & John M. Wunderlich, *Fraud Created the Market*, 63 ALA. L. REV. 275, 310 (2012) ("The class-action device is vital to deterring securities fraud and remedying its victims . . . ."); Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 976 (1993) ("[D]erivative and class actions survive in their present form even though there is little evidence that they benefit investors either through monetary recovery or the deterrence of management from fiduciary breaches or other illegal acts.").

17. *See, e.g.*, Richard A. Booth, *The End of Securities Fraud Class Action?*, REGULATION MAG., Summer 2006, at 46, *available at* http://www.cato.org/pubs/regulation/regv29n2/v29n1-8.pdf.

Specifically, these critics have argued "that securities fraud class action suits were driven by lawyers, not clients; based on stock price movement, not genuine fear of fraud; seeking quick settlement, not resolution on the merits; and were unjustly hampering capital formation, not legitimately policing market malfeasance."[18] Yet others maintain the importance of private rights of action as incentives for corporations to abide by securities regulation.[19] This controversy is most apparent in (A) the evolution of the private cause of action, (B) the emergence of the class action, (C) the perceived abuses of securities litigation, and (D) the reforms prompted by those perceived abuses.

### *A. Holistic Regulation: Judicial Impetus and Congressional Support for the Original Private Right of Action Under Federal Securities Laws*

States promulgated the first securities regulations prior to the Civil War.[20] The first antifraud provisions, however, did not appear until the 1910s.[21] These state antifraud rules, many of which still exist today, are commonly referred to as "blue sky laws," though there exists entertaining disagreement about the root of this term.[22] Notably, these first attempts at regulating securities fraud were not typically accompanied by private rights of action.[23] Instead, blue sky laws were "usually enforced through investigation by State officers, by criminal prosecutions, or by the issuance of injunctions by the courts."[24] Even today, not all states (for example, New York) recognize a private right of action under their blue sky laws.[25]

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18. Shannon Rose Selden, *(Self-)Policing the Market: Congress's Flawed Approach to Securities Law Reform*, 33 J. LEGIS. 57, 72 (2006).

19. *See, e.g.*, Neil Pandey-Jorrin, *A Case for Amending the Private Securities Litigation Reform Act: Why Increasing Shareholders' Rights to Sue Will Help Prevent the Next Financial Crisis and Better Inform the Investing Public*, BUS. L. BRIEF, Spring 2009, at 15, 19 (arguing that reducing plaintiff's barriers to access private rights of action for securities fraud will improve corporate transparency).

20. Gerald D. Nash, *Government and Business: A Case Study of State Regulation of Corporate Securities, 1850-1933*, 38 BUS. HIST. REV. 144, 146-48 (1964).

21. Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 279-80 (1998).

22. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359 n.59 (1991) (noting that the term's origin was already forgotten before 1920 and explaining the lingering arguments that the term derived from "the fly-by-night operators in Kansas operated so blatantly that they would 'sell building lots in the blue sky in fee simple'" or from "the idea that the 'maker of bad paper might just as well be capitalizing the blue sky and selling shares therein'").

23. Nash, *supra* note 20, at 151.

24. *Id.*

25. Perino, *supra* note 21, at 283.

The stock market crash of October 1929 and the ensuing Great Depression prompted Congress to enact the first federal securities regulation.[26] This "regulatory overhaul," which resulted in the passage of the Securities Act and the Exchange Act, was soon followed by multiple variations of civil liabilities:

> [T]he Securities Act of 1933 expressly provided rights of action for selling securities without registration or under misleading registration statements; the Securities Exchange Act of 1934 . . . provided express rights of action for participating in price manipulation, insider trading, and filing false documents; and the Exchange Act created an implied right of action in a catch-all prohibition against securities fraud in § 10(b).[27]

The SEC, established by the Exchange Act, bears primary responsibility for enforcing securities regulations.[28] Like all regulatory bodies, however, the SEC's resources are finite.[29] As a result, many view private litigation as the final piece of the puzzle that enables "holistic regulation" of the securities markets.[30] Supporters believe that by pursuing claims beyond the capacity of the SEC, private enforcement helps ensure that securities fraud does not go undeterred.[31]

### *B. Game Changer: The Introduction of Class Actions*

The creation of the modern class-action device in the 1960s significantly changed the landscape for private securities litigation.[32] In fact, "a leading justification" for the introduction of the modern device was the application of the class action in securities litigation.[33] Most notably, in 1941, Harry Kalven, Jr. and Maurice Rosenfield advocated for something very close to the modern

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26. COX, *supra* note 11, at 2.

27. Shuenn (Patrick) Ho, *A Missed Opportunity for "Wall Street Reform": Secondary Liability for Securities Fraud After the Dodd-Frank Act*, 49 HARV. J. ON LEGIS. 175, 176 (2012) (internal citations omitted).

28. 15 U.S.C. § 78d (2012).

29. *See* COX, *supra* note 11, at 745.

30. Kaufman & Wunderlich, *supra* note 16, at 280.

31. *Id.*

32. Mordecai Rosenfeld, *The Impact of Class Actions on Corporate and Securities Law*, 1972 DUKE L.J. 1167, 1167.

33. STEPHEN C. YEAZELL, FROM MEDIEVAL GROUP LITIGATION TO THE MODERN CLASS ACTION 232 (1987).

class action.[34] They argued that representative litigation could be particularly useful "as a supplement to governmental regulation of large, diffuse markets like those in securities."[35] They saw the potential for class actions to uniquely "supplement regulatory agencies both by requiring wrong-doers to give up their ill-gotten gains and by ferreting out instances of wrong that might have escaped the regulators' observance."[36]

In 1966, the federal class-action rule, Rule 23 of the Federal Rules of Civil Procedure, was entirely revamped with an eye toward protecting individuals.[37] Following the amendment, federal courts experienced the boom of the emergence of the class action.[38] Drafters of the new Rule 23 had hoped to attract lawyers to pursue claims on behalf of wronged shareholders by allowing plaintiffs' attorneys "to bundle relatively low-value claims" to an amount worthy of the pursuit of recovery.[39] And attract plaintiffs' lawyers they did. Immediately, anti-fraud class actions were filed under the 1930s Securities Acts.[40] Plaintiffs' attorneys saw the class-action device as a "*beneficial*" contribution to securities regulation, noting that "financial statements and press releases are doubtless becoming more accurate because of the fear of a class action."[41] But even as early as the 1970s, "critics of class actions . . . asserted that section 10(b) [of the Exchange Act] ha[d] been so over-used and misused as to demonstrate the unworthiness of the class action device."[42]

In critiquing securities fraud class actions, frequent contributor to securities academia, Michael Perino, argues that Congress could not have anticipated the modern landscape of securities litigation when drafting the securities regulation regime.[43] And it is most likely correct that the original drafters of the 1933 and 1934 Acts did not contemplate class actions in their

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34. *Id.* (citing Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684 (1941)).

35. *Id.* (citing Kalven, Jr. & Rosenfield, *supra* note 34).

36. *Id.*

37. Rosenfeld, *supra* note 32, at 1167-68, 1190.

38. *Id.* at 1167.

39. Judith Resnik, *Lessons in Federalism from the 1960s Class Action Rule and the 2005 Class Action Fairness Act: "The Political Safeguards" of Aggregate Translocal Actions*, 156 U. PA. L. REV. 1929, 1939 (2007-2008).

40. *See* Rosenfeld, *supra* note 32, at 1167.

41. *Id.* at 1167 ("[P]erhaps the greatest impact of the class action has been its deterrent effect . . . .").

42. *Id.* at 1175.

43. Perino, *supra* note 21, at 283.

contemporary form.[44] Drafters of the Federal Rules of Civil Procedure, however, certainly considered the class action's application to securities fraud.[45]

Regardless, by the 1990s, abuses of the securities litigation class action were at least perceived as rampant (although the degree to which the class-action device was actually abused during that period continues to be a subject of debate).[46] These perceptions eventually led to the judicial and congressional curtailment of both class actions and private rights of action under the securities laws.[47]

### *C. Strike Suits and Settlements: Perceived Abuses of the Securities Fraud Class Actions*

Howard Sirota, an active plaintiffs' attorney in securities class actions, accounted that by the 1990s, although securities fraud class actions were once acclaimed "as a way of policing the system," it had become so that "filing a securities class action [was] akin to molesting a child."[48] Although a plaintiffs' attorney, Mr. Sirota condemned the prevalent practice of strike suits.[49] Mr. Sirota claimed that because of these suits by his "so-called colleagues," attorneys like him who made a practice by actually uncovering fraud were "having a harder and harder time convincing judges that a case [wa]s an actual fraud because too many people ha[d] cried 'fraud' for every earnings disappointment."[50]

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44. *Id.* at 283-84. *But see* Rosenfeld, *supra* note 32, at 1167 n.3 (1972) ("The original Federal Rules of Civil Procedure became effective in 1938, but class actions in the United States date back in time to at least before Equity R. 38, 226 U.S. 659 (1912).") (citing Supreme Tribe of Ben-Hur v. Cauble, 255 U.S. 356 (1921); Smith v. Swormstedt, 57 U.S. (16 How.) 288 (1853)).

45. *See supra* Part II.A.

46. Avery, *supra* note 2, at 339.

47. *See infra* Parts II.C, III.

48. Diana B. Henriques, *Making It Harder for Investors to Sue*, N.Y. TIMES, Sept. 10, 1995, § 3, at 5, *available at* http://www.nytimes.com/1995/09/10/business/investing-it-making-it-harder-for-investors-to-sue.html?pagewanted=all&src=pm (quoting Howard Sirota, a plaintiffs' attorney with a record of major successful securities class actions).

49. *Id.* "Strike suits" refer to suits that "mak[e] charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them." Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966). In the context of securities fraud litigation, strike suits specifically refer to cases that obtain settlement value because of the high price of discovery, even though they were filed in response to mere stock price drops without any affirmative showing of wrongdoing. H.R. CONF. REP. NO. 104-369, at 31 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730.

50. Henriques, *supra* note 48, at 5.

By the 1990s, lobbyists of emerging Silicon Valley technology firms stood at the forefront of the debate leading to reforms, claiming that plaintiffs' class-action attorneys had inflicted meritless securities fraud suits on "[m]ore than half of the top 150 Silicon Valley firms."[51] The assertion, however, presents quite a proof problem. Because most of these "meritless" suits were settled to avoid litigation, it is unclear how often firms settled with knowledge of the claims' merits. As some securities class-action attorneys stated in the 1990s, "the corporate habit of settling cases instead of fighting them before a judge or jury can make even specious fraud claims look valid."[52] Simultaneously, opponents of securities litigation reform pointed to the benefits of securities litigation as a deterrent that allowed corporate attorneys to incentivize their clients to comply with the regulations.[53] They also attempted to persuade Congress of the private action's positive impact on the financial markets by pointing to increasing numbers of initial public offerings and successful exposure of fraudulent practices leading to investor compensation for wrongs.[54]

Naturally, many companies would be induced to settle even a meritless securities fraud case if it survived a motion to dismiss, as avoiding discovery alone can allow the companies to avoid approximately 80 percent of the costs of the action in some cases.[55] That said, SEC Chairman Arthur Levitt confessed the difficulty in "measure[ing] how prevalent strike suits are, or even [determining] whether the problem is any more serious today than it

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51. G. Pascal Zachary & Jill Abramson, *Silicon Volley: High-Tech Firms Rush to Fund a Pet Cause: Chill All the Lawyers – A Former Intuit Ace Leads California Battle to Curb Lawsuits and Huge Fees – Finding Rewards in Politics*, WALL ST. J., Mar. 11, 1996, at A1.

52. Henriques, *supra* note 48, at 4.

53. *See, e.g.*, *Securities Litigation Reform Proposals S.240, S.667, and H.R. 1058: Hearings Before the Subcomm. on Sec. of the Comm. on Banking, Hous. & Urban Affairs*, 104th Cong. 207, at 195 (1995) [hereinafter *Reform Act Senate Hearings*] (statement of Sheldon H. Elsen, the Association of the Bar of the City of New York) (recalling his experience as a young associate when, after neither case law nor ethics could dissuade a client from violating securities law, being told that if the client "'insist[s] on going ahead with the deal, tell them that, if they do, Abe Pomerantz will sue them. That's the only thing that will stop them.'").

54. *See id.* at 206 (statement of Mark J. Griffin, Director of Commerce Division, Utah Department of Commerce, North American Securities Administrators Association, Inc.) (quoting STAFF OF S. SUBCOMM. ON SECS. OF THE COMM. ON BANKING, HOUS. & URBAN AFFAIRS, 103D CONG., PRIVATE SECURITIES LITIGATION 10 (Comm. Print 1994).

55. *See id.* at 52 n.17 (statement of J. Carter Reese, Jr., Chairman, Capital Markets Regulatory Reform Project, Center for Strategic and International Studies).

was ten or twenty years ago."[56] Moreover, the Congressional Research Service study on the subject proved inconclusive, determining that the pervasiveness of strike suits was "less than clear."[57]

Prior to the 1990s reforms, the U.S. Supreme Court also perceived and responded to increasing instances of abuse. For instance, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Court held that a private right of action did not exist for an "aiding and abetting suit under § 10(b)."[58] This occurred after both "the courts and the SEC" recognized this private right of action in "*hundreds* of judicial and administrative proceedings in every Circuit in the federal system."[59] Similarly in *Gustafson v. Alloyd Co.*, in a 5-4 decision the Court limited the private right of action for a fraudulent prospectus only to public offerings by the issuer, despite the express provisions in section 12(2) of the Securities Act.[60] Justice Thomas's dissent, which was joined by Justices Scalia, Breyer, and Ginsberg, accused the majority of being "motivated by its policy preferences" and "assum[ing] that Congress could never have intended to impose liability on sellers engaged in secondary transactions."[61] Still today, the Court continues to be suspicious of the merit of securities class actions.[62]

### *D. The Reforms Prompted by the Perceived Abuses: The Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998*

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

In response to the concern regarding the perceived abuses of securities litigation, particularly the class-action device, Congress enacted the Reform Act over presidential veto in 1995.[63] The Reform Act applies to class actions,

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56. Avery, *supra* note 2, at 340 (quoting Arthur Levitt, Private Litigation Under the Federal Securities Laws, Address at the Securities Regulation Institute 3 (Jan. 26, 1994) (on file with *The Business Lawyer*, University of Maryland School of Law)).

57. *Id.* at 340 n.21 (citing GARY W. SHORTER, CONG. RESEARCH SERV., 95-656E, SECURITIES LITIGATION REFORM: HAVE FRIVOLOUS SHAREHOLDER SUITS EXPLODED?, at CRS-34 (May 16, 1995)).

58. 511 U.S. 164, 191 (1994), *superseded in part by statute*, 15 U.S.C. § 78t(e).

59. *Id.* at 192 (Stevens, J., dissenting).

60. 513 U.S. 561, 580 (1995).

61. *Id.* at 594 (Thomas, J., dissenting).

62. Dodson, *supra* note 1 ("The Supreme Court's 2010 Term in particular evinces both skepticism of and hostility to class actions [and] . . . the assault on class actions is coming so forcefully from all sides.").

63. Avery, *supra* note 2, at 337-38, 352-53.

but it only applies to class actions filed in federal court.[64] Some of the Act's most noted provisions include (1) a heightened pleading requirement for claims brought under section 10(b) of the Exchange Act and Rule 10b-5 of the related SEC rules,[65] (2) a discovery stay pending motions to dismiss,[66] (3) mandatory sanctions for Federal Rule of Civil Procedure 11(b) violations,[67] and (4) lead-plaintiff designation requirements.[68] Additionally, the Reform Act created a safe harbor for forward-looking statements, which reduced the potential liability for predictive statements.[69]

President Clinton vetoed the bill, despite his support of its goals, because of his concerns that it would shut out plaintiffs with legitimate claims.[70] He specifically stated his objections to the heightened pleading requirements as posing "an unacceptable procedural hurdle to meritorious claims," the low standard for cautionary language that would entitle defendants to use the forward-looking statement safe harbor, and the mandatory Rule 11 sanctions as coming "too close to the 'loser pays' standard."[71]

Purportedly, the Reform Act was aimed at the specific evils of strike suits, namely greedy lawyers and professional plaintiffs.[72] The Reform Act, however, severely restricted the ability of all class-action plaintiffs to survive a motion to dismiss by limiting access to discovery and increasing the pleading requirements.[73] Prior to enactment of the Reform Act, all securities

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64. *See* 15 U.S.C. § 78u-4(a) (2012).

65. *See id.* § 78u-4(b)(1)(B) ("[T]he complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."); *id.* § 78u-4(b)(2)(A) ("[T]he complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."); *see also* Selden, *supra* note 18, at 76.

66. 15 U.S.C. § 78u-4(b)(3); *see also* Selden, *supra* note 18, at 76.

67. 15 U.S.C. § 78u-4(c) (requiring a court to "include in the record specific findings regarding compliance" with "Rule 11(b) of the Federal Rules of Civil Procedure" and to "impose sanctions" upon a finding of a violations).

68. *Id.* § 78u-4(a)(3); *see also* Selden, *supra* note 18, at 76.

69. 15 U.S.C. § 77z-2 (2012) (amending the Securities Act of 1933, 15 U.S.C. §§ 77a-77pp (2012)); 15 U.S.C. § 78u-5(c) (2012) (amending the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78pp (2012)).

70. William J. Clinton, *Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States*, H.R. DOC. NO. 104-150, *reprinted in* 141 CONG. REC. H15214 (daily ed. Dec. 20, 1995).

71. *Id.*

72. *See* Selden, *supra* note 18, at 72.

73. Phillips, *supra* note 3, at 1015-18.

fraud claims were already subject to the heightened pleading standards of Federal Rule of Civil Procedure 9(b), which requires that "a party must state with particularity the circumstances constituting fraud or mistake."[74] The higher standards created by the Reform Act "insis[t] that securities fraud complaints 'specify' each misleading statement; that they set forth the facts 'on which [a] belief' that a statement is misleading was 'formed'; and that they 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'"[75] These hurdles have posed and continue to pose challenges to all plaintiffs, whether or not their claims lack merit.

Nineteen months after the passage of the Reform Act, the securities landscape remained essentially unchanged.[76] Overall, the aggregated state and federal litigation rates following 1995 remained constant and were consistent with the rates of litigation prior to the passage of the Reform Act.[77] Those statistics, however, encompassed "a significant shift" of litigation to state court,[78] whereas prior to the Reform Act, securities class actions were filed almost exclusively in federal court.[79] Additionally, a new defendant emerged in these state-court actions.[80] While approximately 89% of the suits filed prior to the Reform Act were filed against non-publicly traded companies, 81.5% of the suits filed after the Reform Act targeted defendants that "trade[d] on national markets."[81] Perhaps most relevant to the goals of the Reform Act's drafters, the average drop in stock price as a result of filings jumped from 19% prior to the Reform Act to 31% after, which can be interpreted to indicate that a greater number of these suits were meritorious.[82] In contrast, this can also be interpreted to indicate that the market was giving more weight to claims filed because the Reform Act purported to weed out

74. FED. R. CIV. P. 9(b); Selden, *supra* note 18, at 74.

75. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005) (quoting 15 U.S.C. §§ 78u-4(b)(1), (2) (2012)).

76. *Ten Things We Know*, *supra* note 4, at Part I(1).

77. *Id.*

78. *Id.* at Part I(2). For a more in-depth review of the early effects of the Reform Act, see Edward Brodsky, *Discovery Abuses: A Shifting Target?*, White-Collar Crime Rep. (Bloomberg BNA), July/Aug. 1997, at 1, *available at* Westlaw, 11 No. 7 ANWCCR 1.

79. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 82 (2006) (citing H.R. REP. NO. 105-640, at 10 (1998); S. REP. NO. 105-182, pp. 3-4 (1998)).

80. *See Ten Things We Know*, *supra* note 4, at Part I(2).

81. *Id.*

82. *Id.* at Part I(4).

meritless claims. Of all of these emerging realities, it was the dramatic shift of litigation from federal court to state court that most concerned Congress.[83]

Unsurprisingly, another great debate emerged about what caused that shift.[84] Advocates of further reform accounted for this shift by pointing to the motives for plaintiffs' attorneys to avoid the Reform Act by filing in state court rather than federal court.[85] They referred to this as "[s]trategic evasion."[86] Professor Grundfest of Stanford University explained:

> Plaintiffs could, without limitation, pursue state litigation in order to: (1) take discovery that would be prohibited by a federal stay; (2) avoid defenses available pursuant to the federal forward-looking safe harbor; (3) plead cases where the facts alleged would be insufficient to avoid dismissal in a federal court; (4) avoid the need for the designation of a lead plaintiff; or (5) avoid heightened scrutiny of settlement terms.[87]

On the other hand, a leading plaintiffs' counsel at the time enumerated many "legitimate" reasons why a plaintiff would choose state court over federal court, particularly after the passage of the Reform Act:

> [M]any state courts permit plaintiffs to recover on a 9-to-3 jury vote, as opposed to unanimous verdicts required in the federal system; many state laws permit a recovery upon a showing of negligence, as opposed to recklessness or intentional misconduct, and some states permit recovery without any showing of reliance.[88]

Regardless of any potential legitimacy in the shift to state court, the result was congressional action in the form of the Uniform Standards Act.[89]

*2. The Securities Litigation Uniform Standards Act of 1998*

In enacting the Uniform Standards Act, the 105th Congress found that, to avoid the strategic evasion of the Reform Act, "it is appropriate to enact

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83. *See* Uniform Standards Act, *supra* note 5 ("An Act To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to limit the conduct of securities class actions under State law, and for other purposes.").

84. *See, e.g.*, Brodsky, *supra* note 78, at 2.

85. *Ten Things We Know*, *supra* note 4, at Part III.

86. *Id.*

87. *Id.* (citations omitted).

88. *Id.* (quoting William S. Lerach, Private Securities Litigation Reform Act 1995 [sic] 1 & 1/2 Years Later at 11 (n.d.) (alteration omitted) (on file with Grundfest & Perino)).

89. *See* Uniform Standards Act, *supra* note 5.

national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits."[90] Plaintiffs' attorneys had successfully avoided the requirements of the Reform Act by filing state-law actions in state court.[91] As a result, Congress aimed the Uniform Standards Act at preventing class actions from utilizing those schemes.[92] Under the Uniform Standards Act, plaintiffs are barred from bringing "class-actions that (1) consist of more than fifty prospective members; (2) assert state-law claims; (3) involve a nationally listed security; and (4) allege 'an untrue statement or omission of a material fact in connection with the purchase or sale of' that security."[93] Contrary to the characterization of many courts,[94] the Uniform Standards Act does not preclude state law, but rather precludes plaintiffs from using the class-action device to bring certain state-law claims.[95] This approach reflects Congress's "underlying assumptions: that class actions (not state securities laws) are dangerous and federal law must rein them in."[96]

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90. *Id.*

91. *See* Michael A. Rosenhouse, *Validity, Construction, and Operation of Securities Litigation Uniform Standards Act of 1998*, 2 A.L.R. FED. 2D 1, 20 (2005).

92. *See id.*

93. Atkinson v. Morgan Asset Mgmt., Inc., 658 F.3d 549, 552 (6th Cir. 2011) (quoting 15 U.S.C. § 77p(b), (f)(2)(A), (f)(3)). The Uniform Standards Act provides exceptions from its preclusion to "certain class actions based on the law of the State in which the issuer of the covered security is incorporated, actions brought by a state agency or state pension plan, actions under contracts between issuers and indenture trustees, and derivative actions brought by shareholders on behalf of a corporation." Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 87 (2006) (citing 15 U.S.C. §§ 78bb(f)(3)(A)-(C), (f)(5)(C)).

94. *See, e.g.*, Dixon v. ATI Ladish LLC, 667 F.3d 891, 894 (7th Cir. 2012) (stating that the Uniform Standards Act preempts "most state-law securities suits brought as class actions"); Rowinski v. Salomon Smith Barney Inc., 398 F.3d 294, 305 (3d Cir. 2005) (stating that the Uniform Standards Act "does not preempt particular 'claims' or 'counts' but rather preempts 'actions'") (citing 15 U.S.C. § 78bb(f)(1)); Behlen v. Merrill Lynch, 311 F.3d 1087, 1092 (11th Cir. 2002) ("To that end, the [Uniform Standards Act] preempts certain state law claims, allows for removal of state actions to federal court, and requires immediate dismissal of 'covered lawsuits.'") (citing Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1341 (11th Cir. 2002)).

95. *See* Kircher v. Putnam Funds Trust, 547 U.S. 633, 636 n.1 (2006) ("The preclusion provision is often called a preemption provision; the [Uniform Standards 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.").

96. Selden, *supra* note 18, at 79 (citing A.C. Pritchard, *Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998*, 78 WASH. U. L.Q. 435, 437 (2000)).

The procedural application of the Uniform Standards Act is unusual.[97] Normally, when federal law preempts state law, a state court will determine whether the particular claim has been preempted.[98] In contrast, the federal courts have exclusive jurisdiction to determine whether the Uniform Standards Act precludes plaintiffs' action.[99] Presumably, this was intended to avoid extensive state-law disagreement about when these suits were precluded.[100] Even though the plaintiffs may have filed a state-law claim in state court, by filing a claim that meets the requirements of the Uniform Standards Act "the plaintiff has necessarily invoked federal question jurisdiction."[101] As a result, when defendants assert the applicability of the Uniform Standards Act, the case is removed to federal court to determine whether the action is in fact precluded by the Uniform Standards Act.[102] Once the claim has been removed to federal court, "the court must dismiss for failure to state a claim because [the Uniform Standards Act] has preempted [sic] the state law basis for the claim."[103] Because of the nature of the removal process, the claim may be subject to dismissal with prejudice before the plaintiffs ever have the opportunity to amend their complaint.[104]

Although the Supreme Court has not specifically ruled on when a pleading has alleged a misrepresentation, the Court has provided some guidance as to how the Act might be interpreted generally.[105] In *Merrill Lynch, Pierce,*

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97. *See* Selden, *supra* note 18, at 79.

98. *Id.*

99. *Id.*

100. *Id.* ("Congress (and the corporate lobby) feared that if class actions alleging state fraud claims were preempted but not removed, extensive litigation over whether or not the claims were covered could still continue in state court.").

101. 15A DAVID A. LIPTON, BROKER-DEALER REGULATION § 5:16 (2012) (citing Felton v. Morgan Stanley Dean Witter & Co., 429 F. Supp. 2d 684, 692 (S.D.N.Y. 2006)).

102. 15 U.S.C. § 77p(c) (2012).

103. LIPTON, *supra* note 101, § 5:16 (citing *Felton*, 429 F. Supp. at 692). Note that under the Uniform Standards Act, plaintiffs may still bring a federal claim in state court without removal as the Uniform Standards Act only precludes state-law claims. *Id.* (citing IRRA v. Lazard Ltd., No. 05 CV 3388 RJDRML, 2006 WL 2375472, at *2 (E.D.N.Y. 2006)).

104. *See, e.g*. Atkinson v. Morgan Asset Mgmt., Inc., 658 F.3d 549, 556 (6th Cir. 2011) (dismissing with prejudice even though plaintiffs "had no chance to request amendment prior to the court's dismissal").

105. It is possible that this precedent may change or be clarified in the near future, as the Supreme Court has recently granted certiorari on a series of consolidated cases on the issue of whether "a covered state law class action complaint that unquestionably alleges 'a' mispresentation 'in connection with' the purchase or sale of a SLUSA-covered security nonetheless can escape the application of SLUSA by including other allegations that are farther removed from a covered securities transaction." United States Supreme Court, Question Presented Report No. 12-86 (Jan. 18, 2013), *available at* http://www.

*Fenner & Smith Inc. v. Dabit*, the Supreme Court addressed whether the claims made by holders of securities were "'in connection with the purchase or sale' of securities."[106] In determining that holder claims are precluded by the Uniform Standards Act, the Supreme Court broadly interpreted the Uniform Standard Act's language.[107]

The Court ultimately concluded that "[a] narrow reading of the [Uniform Standards Act] would undercut the effectiveness of the 1995 Reform Act and thus run contrary to [the Uniform Standard Act]'s stated purpose."[108] It based this determination on a number of factors within the Uniform Standards Act itself. The Court pointed to the numerous exceptions to the preclusion provided within the statute, which "make[] it inappropriate for courts to create additional, implied exceptions."[109] Further, because the Uniform Standard Act's preclusion "does not actually pre-empt any state cause of action" but rather only "denies plaintiffs the right to use the class-action device to vindicate certain claims," the Court determined it is unnecessary to interpret the statute narrowly as it might otherwise in a federal preemption situation.[110] Additionally, because state law had not been the traditional "vehicle for asserting class-action securities fraud claims,"[111] the Court chose to read the preclusive sweep broadly and noted that the Uniform Standards Act does not preempt "a historically entrenched state-law remedy."[112] As a result, *Dabit* is now characterized as directing courts to "broadly interpret [the Uniform Standards Act] in order to carry out the congressional intent to limit abusive class actions."[113] The broad interpretation of an already broad statute has resulted in mixed circuit court interpretations of the ambiguous provisions.

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supremecourt.gov/qp/12-00086qp.pdf (granting certiorari on *Chadbourne & Parke LLP v. Troice*, *Proskauer Rose LLP v. Troice*, and *Willis of Colorado Inc. v. Troice* for the October 2013 Term).

106. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 83-84 (2006) (finding undisputed "that the complaint alleg[ed] misrepresentation and omissions of material facts").

107. *See id.* at 88-89.

108. *Id.* at 86.

109. *Id.* at 87-88; *see also supra* note 93 and accompanying text.

110. *Dabit*, 547 U.S. at 87.

111. *Id.* at 88 (citing H.R. REP. NO. 105-803, at 14 (1998) (Conf. Rep.)).

112. *Id.*

113. Jennifer J. Johnson, *Securities Class Actions in State Court*, 80 U. CIN. L. REV. 349, 356 (2011) (citing *Dabit*, 547 U.S. at 85).

### *III. The Circuit Split About Whether a Complaint Has Alleged Fraud or Misrepresentation: The Literalist,* La Sala*, and Intermediate Approaches*

Because the Supreme Court has not addressed the "allegation of misrepresentation" element of Uniform Standards Act preclusion, the issue has been left with the federal appellate courts for resolution. The circuits have generated three distinct tests.[114] In *Brown v. Calamos*, Judge Posner outlined and titled these three approaches: the Literalist Approach, *La Sala* Approach, and Intermediate Approach.[115] This section reviews each of the approaches in turn.

#### *A. The* La Sala *Approach: Plaintiffs' Friend*

The Third Circuit's *La Sala* Approach, established in *La Sala v. Bordier et Cie*,[116] is by far the friendliest to plaintiffs of the three interpretations. According to this approach, "[I]f proof of a misrepresentation or of a material omission is inessential to the plaintiff's success, the allegation is no bar to the suit."[117] In other words, this approach differentiates between an inessential allegation and an allegation that may have bearing on the outcome of the case, even if it does not prove an essential element. The latter will bring the case under the purview of Uniform Standards Act, but the former will permit the case to continue.[118] But *La Sala* was not the Third Circuit's first encounter with the misrepresentation element of the Uniform Standards Act. In fact, it first confronted the issue in *Rowinski v. Salomon Smith Barney, Inc.*, in which it issued an arguably contradictory holding.[119]

The plaintiffs in *Rowinski* alleged multiple state theories of liability deriving from their chief allegation that the defendant, an investment brokerage firm, had dispersed research that was "biased in favor of the firm's investment banking clients, to the detriment of its retail brokerage customers."[120] The district court dismissed the claims finding them precluded by the Uniform Standards Act following removal from state court.[121]

The Third Circuit agreed with the lower court's reasoning that the Uniform Standards Act precluded the claim because it "alleged a misrepresentation or

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114. *See* Brown v. Calamos, 664 F.3d 123, 127 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).
115. *Id.*
116. 519 F.3d 121 (3d Cir. 2008).
117. *Brown*, 664 F.3d at 127.
118. *Id.*
119. 398 F.3d 294 (3d Cir. 2005).
120. *Id.* at 296.
121. *Id.*

omission of a material fact in connection with the purchase or sale of a covered security."[122] The plaintiffs contended that the breach of contract claims should be allowed to proceed because misrepresentation is not an element of breach of contract claims.[123] The Third Circuit rejected their argument for two reasons.[124] First, after investigating the plain language of the statute, the court determined that preclusion occurs when any of the Uniform Standards Act's "prerequisites are 'alleged' in one form or another."[125] Second, the court recognized that allowing allegations of fraud and misrepresentation to trigger preclusion only when essential to the state-law claims' elements threatens Congress's intent that the "bill be interpreted broadly."[126] Ultimately, the *Rowinski* court held that "the misrepresentation prong is satisfied under [the Uniform Standards Act]" when "allegations of a material misrepresentation serve as the factual predicate of a state law claim."[127]

Three years after *Rowinski*, a panel of three different Third Circuit judges presided over *La Sala v. Bordier et Cie* and developed what Judge Posner labeled as the *La Sala* Approach.[128] In *La Sala*, the plaintiffs were trustees of a trust created in the bankruptcy proceedings of AremisSoft, whose demise began when high-level directors "executed a classic 'pump and dump' scheme."[129] To settle a federal securities class action in response to the pump and dump scheme, which was filed prior to the bankruptcy proceeding, a plan was implemented giving all the individual and group claims from the class action to a state-law trust.[130] The trust was then "responsible for prosecuting and distributing to the [original claimants] the proceeds of all of the claims."[131] The two trustees filed suit in district court alleging claims for "aiding and abetting a breach of fiduciary duty" and "violating Swiss money-laundering laws."[132] The district court dismissed the claims, finding the action precluded by the Uniform Standards Act because it was a class action

122. *Id.* at 297.
123. *Id.* at 300.
124. *Id.* (citing 15 U.S.C. § 78bb(f)(1)).
125. *Id.*
126. *Id.* (citing S. REP. NO. 105-182, at 8 (1998), *available at* 1998 WL 226714).
127. *Id.*
128. La Sala v. Bordier et Cie, 519 F.3d 121, 126 (3d Cir. 2008).
129. *Id.* at 126-27.
130. *Id.*
131. *Id.* at 127.
132. *Id.*

and contained allegations of "misrepresentations in connection with securities trades."[133]

The Third Circuit reversed the holding of the district court primarily because it determined the action was not a class action, and therefore the Uniform Standards Act could not apply.[134] The court nonetheless continued its analysis to assess whether the foreign-law claims were precluded by the Uniform Standards Act.[135] The Third Circuit elucidated the holding in *Rowinski*, explaining that the misrepresentation element of Uniform Standards Act preclusion is satisfied "when an allegation of a misrepresentation in connection with a securities trade is a 'factual predicate' of the claim, even if misrepresentation is not a legal element of the claim."[136] Specifically, the court stated that *Rowinski* did not hold that all allegations of misrepresentation would operate to satisfy the misrepresentation element of the Uniform Standards Act.[137] Although technically dicta, the Third Circuit explained that in *La Sala*, the misrepresentations alleged in reference to the Swiss-law claims failed to implicate the misrepresentation element because the facts were "merely background details that need not have been alleged, and need not be proved."[138] As a result, through *La Sala* the Third Circuit developed an approach through which the pleadings could include allegations of fraud but nonetheless survive Uniform Standards Act preclusion.

### *B. The Literalist Approach: Bright-Line Rough Justice*

According to the Literalist Approach, if a complaint alleges "'a misrepresentation or . . . omission of a material fact in connection with the purchase or sale of a covered security,'" the inquiry ends there.[139] The case should be dismissed with prejudice, regardless of the importance of the allegation of omission or misrepresentation to the plaintiffs' claim.[140] The

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133. *Id.* at 129.

134. *Id.* at 132-33, 135. Based on its investigation of legislative history and the text of the Uniform Standards Act, the court determined that the district court erred in deeming the action a class-action because a trust should not be interpreted to include all of its members. *Id.* at 134-36 (citing S. REP. NO. 105-182, at 8 (1998); 15 U.S.C. §§ 78bb(f)(5)(B)(i), 78bb(f)(5)(C), 78bb(f)(5)(D)).

135. *Id.* at 140-41.

136. *Id.* at 141 (quoting Rowinski v. Salomon Smith Barney Inc., 398 F.3d 294, 300 (3d Cir. 2005)).

137. *See id.*

138. *Id.*

139. Brown v. Calamos, 664 F.3d 123, 127 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).

140. *Id.*

Sixth Circuit developed this plaintiff-hostile approach in *Segal v. Fifth Third Bank, N.A.*,[141] and it applied and expanded the approach in *Atkinson v. Morgan Asset Management*.[142] Judge Posner labeled this the Literalist Approach presumably because it commands a literal interpretation of the language in the Uniform Standards Act without permitting any room for plaintiff error.

In *Segal*, the plaintiffs were beneficiaries of trust accounts handled by the defendants.[143] Among many allegations, the plaintiffs' amended complaint asserted that defendants, who were a bank and its holding company, had misrepresented the management style of the trust funds, "intentionally and 'knowingly overcharged' its trust clients," withheld from investors that "their trust accounts would be invested in proprietary mutual funds," and "made misrepresentations to the trust beneficiaries and otherwise manipulated them 'in connection with' the sale of [the bank's] mutual funds."[144] The plaintiffs, however, included in their amended complaint the following statement: "None of the causes of action stated herein are based upon any misrepresentation or failure to disclose material facts to plaintiff."[145] The district court nonetheless dismissed the case for failure to state a claim, finding that all claims contained within the complaint were barred by the Uniform Standards Act.[146]

The only issue on appeal to the Sixth Circuit was whether the complaint included allegations of a misrepresentation "'in connection with the purchase or sale' of [the bank's] mutual funds."[147] The court held that the Uniform Standards Act bars complaints that include allegations of fraud or misrepresentation, "pure and simple."[148] It declined to give weight to the plaintiffs' disclaimer that their claims were not based on material misrepresentations, clarifying that the Uniform Standards Act precludes actions that "cover[] the prohibited theories, no matter what words are used (or disclaimed) in explaining them."[149] The circuit court, relying on the *Dabit* Court's call for a broad construction, specifically rejected the interpretation that the Uniform Standards Act only precludes claims that depend on

141. 581 F.3d 305, 311 (6th Cir. 2009).
142. 658 F.3d 549, 554-55 (6th Cir. 2011).
143. *Segal*, 581 F.3d at 308.
144. *Id.* at 310.
145. *Id.*
146. *Id.* at 308.
147. *Id.* at 309.
148. *Id.* at 311.
149. *Id*.

allegations of fraud or misrepresentation.[150] It also specifically rejected the *La Sala* Approach, discussed *supra*, noting that the *La Sala* interpretation of the Uniform Standards Act was only dicta and, furthermore, that it contradicted earlier Third Circuit precedent.[151]

Two years later, the Sixth Circuit seized an opportunity to reiterate its adherence to the approach it adopted in *Segal*. In *Atkinson*, the plaintiffs filed thirteen state-law claims following the 2008 stock crisis, alleging losses due to fraud.[152] Their claims included "breach of fiduciary duty, negligence, and negligent misrepresentation."[153] The plaintiffs' first allegation was that the "[d]efendants 'failed[ed] to provide truthful and complete information about the Funds' portfolios.'"[154] The plaintiffs argued that in order for the Uniform Standards Act to bar a complaint, the claim must "*require* fraud as a *necessary element.*"[155] The district court disagreed in light of the rule established in *Segal* that the Uniform Standards Act "precludes [p]laintiffs' claims because they include allegations of misrepresentations and omissions 'pure and simple.'"[156]

On appeal to the Sixth Circuit, the plaintiffs challenged the district court's dismissal with prejudice, claiming that they should still be allowed to amend their complaint to avoid Uniform Standards Act preclusion "by either removing the fraud allegations from their claims or shaving their class to less than fifty plaintiffs."[157] The plaintiffs experienced particular frustratation because they never had an opportunity to amend their complaint as the federal district court dismissed the action sua sponte upon receiving the plaintiffs' motion to remand.[158] Although declining official appellate review because the plaintiffs had not raised the issue below, the Sixth Circuit nonetheless responded to their concern by explaining the Uniform Standards Act process: "Once a [Uniform Standards Act]-covered action is removed and a plaintiff moves to remand, a motion to dismiss becomes unnecessary because . . . remand itself poses a 'jurisdictional issue.'"[159] Because the court

150. *Id.* (citing Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 86 (2006)).
151. *Id.* at 312 (citing Rowinski v. Salomon Smith Barney, Inc., 398 F.3d 294, 300 (3d Cir. 2005)). Discussion of the *La Sala* approach may be found *supra* Part III.A.
152. Atkinson v. Morgan Asset Mgmt., Inc., 658 F.3d 549, 552 (6th Cir. 2011).
153. *Id.*
154. *Id.* at 554.
155. *Id.* at 555.
156. *Id.* (citing *Segal*, 581 F.3d at 311).
157. *Id.* at 556.
158. *Id.*
159. *Id.*

interpreted the dismissal as jurisdictional but dismissed the case with prejudice, the result was that neither federal nor state courts could hear the plaintiffs' complaints. As a result, a pleading in a circuit exercising this approach risks dismissal if it includes any allegation of fraud or misrepresentation.

*C. The Intermediate Approach: High Standards with a Parachute*

Judge Posner characterized the Ninth Circuit's hybrid approach to analyzing allegations of misrepresentation as the "Intermediate Approach."[160] This functions essentially the same as the Literalist Approach, but instead of dismissing with prejudice, the suit is dismissed without prejudice to allow the plaintiffs the opportunity to craft their complaint to eliminate the allegations of fraud.[161] If the plaintiffs' claims could survive without the allegations of fraud, the plaintiffs can resubmit their complaint without those allegations.

In *Stoody-Broser v. Bank of America, N.A.*, the Ninth Circuit applied traditional procedural rules to determine that dismissal without prejudice is permissible for claims precluded by the Uniform Standards Act.[162] Prior to *Stoody-Broser*, Ninth Circuit case law had already established when a misrepresentation rises to the level of precluding the suit. In *Proctor v. Vishay Intertechnology, Inc.*, the Ninth Circuit read decisions by other circuits, including *Segal* and *Rowinski*, as holding that "[m]isrepresentation need not be a specific element of the claim to fall within the [Uniform Standard Act]'s preclusion."[163]

In *Stoody-Broser*, a Ninth Circuit panel reviewed a case where the district court had dismissed the claims with prejudice upon finding that the claims were barred by the Uniform Standards Act.[164] The Ninth Circuit quickly upheld dismissal of the claims, pointing to direct allegations of omissions that had financially benefitted the defendants.[165] It only departed from the district court in determining whether to dismiss without prejudice.[166] The court considered circuit precedent, which stated that leave to amend should be granted "unless it is clear, upon de novo review, that the complaint could not

160. Brown v. Calamos, 664 F.3d 123, 127 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).

161. *Id.*

162. *See, e.g.,* Gregory Kendall, Comment, *The Artful Dodgers: Securities Fraud, Artful Pleading, and Preemption of State Law Causes of Action*, 81 U. CIN. L. REV. 657, 668 (2012).

163. 584 F.3d 1208, 1222 n.13 (9th Cir. 2009).

164. Stoody-Broser v. Bank of Am., N.A., 442 F. App'x 247, 248 (9th Cir. 2011).

165. *Id.*

166. *Id.*

be saved by any amendment."[167] However, the court determined that it was foreseeable that the Uniform Standards Act might not preclude a claim for "violation of a trust administrator's fiduciary duty to the trust's beneficiaries even where that violation involves trading in covered securities."[168] The court also recognized that in order for such a claim to survive Uniform Standards Act preclusion, the complaint must refrain from alleging "either expressly or implicitly, misrepresentations, omissions, or fraudulent practices coincidental to the violation."[169] As a result, the Ninth Circuit affirmed the earlier dismissal while allowing leave to amend.[170]

Although the *Brown* opinion only cites the Ninth Circuit as permitting amendment post-removal,[171] the Ninth Circuit is not the only circuit to permit amendments to a claim that might otherwise be precluded by the Uniform Standards Act.[172] For example, in *Green v. Ameritrade, Inc.*, the Eighth Circuit reviewed a district court's decision to remand a case back to state court when the plaintiffs' amended complaint no longer included allegations implicating Uniform Standards Act preclusion.[173] The court specifically rejected the merit of the defendant's protests "that 'the essence of the Plaintiff's securities fraud claim, which the district court originally found to be preempted, ha[d] not changed,'" determining instead that the amended complaint no longer implicated the Uniform Standards Act.[174] It held that the district court properly exercised its "broad discretion" in determining to remand the case to state court "[h]aving found no basis for [Uniform Standards Act] preemption of the amended complaint."[175]

## *IV. Analysis: Why Intermediate Is Best*

### *A. To Best Serve the Policies Behind and the Text of the Uniform Standards Act, Courts Should Adopt the Intermediate Approach*

The Intermediate Approach appropriately balances the objectives explicitly and implicitly stated by Congress in the Uniform Standards Act. Besides allowing for dismissal without prejudice, the Intermediate Approach

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167. *Id.* (quoting Gompper v. VISX, Inc., 298 F.3d 893, 898 (9th Cir. 2002)).

168. *Id.* at 249.

169. *Id.*

170. *Id.*

171. Brown v. Calamos, 664 F.3d 123, 127 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).

172. Kendall, *supra* note 162, at 668.

173. 279 F.3d 590, 594 (8th Cir. 2002).

174. *Id.* at 599 (quoting from Br. of Appellants at 3).

175. *Id.*

functions essentially the same as the Literalist Approach. Both approaches command dismissal if an allegation of fraud or misrepresentation coinciding with purchases or sales of securities is present in the complaint, regardless of the importance of the allegation to the plaintiffs' underlying claims.[176] This comports with the Supreme Court's mandate in *Dabit* that the Uniform Standards Act be interpreted broadly because a broad interpretation of "alleging fraud or misrepresentation" captures *any* allegation of fraud or misrepresentation.[177]

The *La Sala* Approach should be rejected because it requires federal judges to make an in-depth inquiry into state-law claims at the pleading stage and determine the mortality of the suit. Such an inquiry itself is contrary to the policy goals of the Uniform Standards Act and the Reform Act. These acts were designed in large part to alleviate the costs associated with defending meritless suits.[178] A judicial practice of assessing the underlying merits requires that defense and plaintiff attorneys alike spend time (and clients' money) briefing and presenting more information than necessary to the ruling at hand.

Essentially, the Uniform Standards Act and the Reform Act lose much of their cachet if they cannot be applied quickly and easily. It is for this reason that the Intermediate Approach is the interpretation that is most respectful of the policy objectives of the Uniform Standards Act.

Still, such a broad interpretation of the preclusive sweep will likely result in the dismissal of claims that could foreseeably continue in state court.[179] Such a harsh standard should not be carried beyond the express mandate of the text. Nowhere in the text does the Uniform Standards Act prohibit amendments post-removal.[180] In fact, there is "statutory silence" regarding whether amendments to complaints should be allowed.[181] And broadly interpreting silence is akin to multiplying zero. Rather, the appropriate

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176. Brown v. Calamos, 664 F.3d 123, 127 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).

177. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 86 (2006).

178. *See* Selden, *supra* note 18, at 72.

179. *See Brown*, 664 F.3d at 129. In *Brown*, Judge Posner acknowledged the case could have been successfully re-filed in state court as a derivative suit but nonetheless dismissed with prejudice. *Id.* at 125, 129, 131.

180. *See* U.S. Mortg., Inc. v. Saxton, 494 F.3d 833, 842-43 (9th Cir. 2007), *abrogated on other grounds by* Proctor v. Vishay Intertechnology, Inc., 584 F.3d 1208, 1226-27 (9th Cir. 2009) ("However, Congress included no express prohibition against amendment and no court has held that [the Uniform Standards Act] completely and categorically bars any amendment of the complaint following removal.").

181. *Id.* at 843.

approach would be to assume that the statute was created against the backdrop of the general rules concerning dismissals with and without prejudice and thus permit leave to amend. Simultaneously, courts should reject the Literalist Approach because it fails to offer relief to plaintiffs with potentially meritorious claims, and therefore makes it more likely that such claims will be forever barred and corporate fraud undeterred. Courts should adopt the Intermediate Approach precisely because it broadly applies the actual text of the Uniform Standards Act with the general rules of procedure in mind.

In contrast to the *La Sala* Approach, the Literalist and Intermediate Approaches allow federal judges to quickly evaluate whether the claim meets the standards for preclusion merely by asking: "Does this complaint allege fraud or misrepresentation in connection with the purchase or sale of a security?" As a result, the Literalist and Intermediate Approaches allow courts to comport with both *Dabit* and the underlying policies of the Uniform Standards Act by providing speedy application of a broad interpretation of the statute.

### *B. Overcoming the Seventh Circuit's Criticism of the Intermediate Approach*

In *Brown v. Calamos*, the court explored the varying circuit approaches before ultimately deciding to reject the Intermediate Approach, although it failed to explicitly accept either of the two remaining approaches.[182] Reviewing the Seventh Circuit's analysis and exposing its weaknesses reveal the true merits of the Intermediate Approach. As such, the following sections present (1) the facts and procedural history of *Brown*, (2) the Seventh Circuit's analysis, (3) a critical examination of that analysis, and (4) the consequences of adopting the Seventh Circuit's logic.

#### *1. Facts and Procedural History of* Brown

The plaintiffs in *Brown* were common shareholders in the Calamos Convertible Opportunities and Income Fund, a "closed-end investment fund" principally comprised of two types of investors: common shareholders and preferred stockholders.[183] The preferred stockholders obtained their stock, which was functionally "a form of bond," through a regularly conducted auction process.[184] The Calamos Fund would then pool the capital of the non-liquid common stock and highly liquid preferred stock for investment.[185]

182. 664 F.3d at 127-31.
183. *Id.* at 125.
184. *Id.*
185. *Id.*

Because of the low interest rates secured through the auction process for preferred stock, the Calamos Fund could make investments with a much greater return than the interest rate owed to the holders of preferred stock, which inured to the benefit of the common shareholders.[186]

In the wake of the 2008 financial crisis, those individuals holding preferred stock did not have anyone to bid against to either unload the stock or adjust the interest rate.[187] As a result, they were stuck both with the stock and the interest rate at the time of the crash, and "that interest rate was low."[188] "[T]hough it had no duty to do so," the Calamos Fund and Calamos Advisors (the Advisors) redeemed the preferred stock, and they redeemed it for a price greater than market value.[189] The Calamos Fund continued to operate and make its investments for the benefit of the common shareholders, but the money replacing the preferred stock investments was "borrowed at higher interest rates" than the preferred stock had required, and it was "borrowed short term."[190] This intensified the riskiness of the Calamos Fund, and as a result, the riskiness of the common shareholders' investment.[191]

Plaintiffs, common shareholders in the Calamos Fund, filed suit against the Fund and its directors alleging that the fund redeemed the preferred stock to benefit the other funds managed by the Advisors.[192] To market the shares of the other Calamos funds, the Advisors relied on banks and brokerage houses "and so needed to maintain the good will of those entities."[193] Following the financial crisis, many entities faced peril through "lawsuits both from regulatory agencies and from disappointed customers."[194] By redeeming the shares, the Advisors were able to extend a safety raft to those banks and brokerage houses, thus preserving those entities' good will and the marketability of the other Calamos Funds.[195]

The plaintiffs filed a class action in state court alleging state-law claims for breach of fiduciary duty.[196] Specifically, the "complaint allege[d] that defendants breached their fiduciary duty to the Fund's common

186. *Id.*
187. *Id.* at 126.
188. *Id.*
189. *Id.*
190. *Id.*
191. *Id.*
192. *Id.*
193. *Id.*
194. *Id.*
195. *Id.*
196. Brown v. Calamos, 777 F. Supp. 2d 1128, 1129 (N.D. Ill. 2011), *aff'd*, 664 F.3d 123 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).

shareholders . . . by causing the Fund to redeem certain preferred shares in a manner that unfairly benefitted the preferred shareholders at the expense of the common shareholders."[197] Defendants removed the action to federal court in the Northern District of Illinois based on preclusion by the Uniform Standards Act and immediately moved for dismissal.[198] The district court dismissed the claim upon finding that "the alleged misstatements are at the heart of plaintiff's claims, which thus fall squarely within [the Uniform Standard Act]'s broad sweep."[199] The plaintiffs appealed to the Seventh Circuit, where the court considered "whether the . . . complaint alleged the misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security and that therefore [the Uniform Standards Act] forbade the suit."[200]

*2. The Seventh Circuit Decision*

Writing for the Seventh Circuit panel, Judge Posner illuminated the reasons for affirming the opinion of the district court, which dismissed the case with prejudice.[201] Judge Posner first identified the allegation of misrepresentations and omissions; namely, the Advisors had failed to inform the common shareholders that, because of the Calamos Advisors' management of multiple funds, the fund might have a conflict of interest that required it to make decisions "motivated by the broader concerns of the entire family of 20 Calamos mutual funds."[202] After establishing the existence of an allegation of an omission, Judge Posner reviewed the circuit approaches to determining at what point an allegation of omission or misrepresentation dooms the suit, outlined *supra*.[203] Although he skated past the Literalist and *La Sala* Approaches, he paused in his discussion of the Intermediate Approach's dismissal without prejudice to voice the Seventh Circuit's concerns.[204]

The court's primary concern was that if the suit were dismissed without prejudice a state court might later be unable or reluctant to forbid the plaintiff from "reinsert[ing] fraud allegations."[205] Judge Posner predicted the

197. *Id.*
198. *Id.*
199. *Id.* at 1132.
200. Brown v. Calamos, 664 F.3d 123, 125 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).
201. *Id.*
202. *Id.* at 127.
203. *Id.*; *see supra* Part III.B.1-3.
204. *Brown*, 664 F.3d at 127.
205. *Id.*

following scenario: Following dismissal without prejudice at the federal level, the plaintiffs would re-file in state court after eliminating all of their offending allegations.[206] Omission of such allegations would offer little comfort, however, because "complaints [do not] strictly control the scope of litigation" in modern jurisprudence.[207] As a result, the state court would either negligently fail to remove the action to federal court, or, perhaps equally damaging, "allow removal of a complex commercial case after, maybe long after, the pleadings stage had been concluded [which] would increase the length and cost of litigation unreasonably."[208]

Similarly, the court disposed of the plaintiffs' argument that "dismissal of a removed suit on the ground that the suit is barred by [the Uniform Standards Act] is jurisdictional and therefore without prejudice."[209] In *Kircher v. Putnam Funds Trust*, the Supreme Court included language that one could reasonably interpret to indicate that preclusion is jurisdictional:

> If the action is precluded, neither the district court nor the state court may entertain it, and the proper course is to dismiss. If the action is not precluded, the federal court likewise has no jurisdiction to touch the case on the merits, and the proper course is to remand to the state court that can deal with it.[210]

The Seventh Circuit explained, however, that the language was intended to indicate merely that the only subject-matter jurisdiction the federal court could have over an otherwise state-law action filed in state court and potentially precluded by the Uniform Standards Act, would be "to determine that it has no jurisdiction" because of the Uniform Standards Act.[211] When the federal court finds that the claim is precluded because of the Uniform Standards Act, the Act serves "as an affirmative defense . . . on the merits."[212] The Seventh Circuit focused particularly on the Supreme Court's word "likewise" in this determination.[213] It reasoned that by "likewise," the Court merely intended to instruct that federal courts lack the power to continue adjudicating the claims and assess the merits of the state-law action, when the district court has found that the Uniform Standards Act fails to bar the

206. *Id.*
207. *Id.*
208. *Id.*
209. *Id.* at 127-28.
210. 547 U.S. 633, 644 (2006).
211. *Brown*, 664 F.3d at 128.
212. *Id.*
213. *Id.*

claim.[214] After removal of a purely state-law claim based on Uniform Standards Act preclusion, the district court's jurisdiction over the claim disappears once it has determined the impact of the Uniform Standards Act on the case.[215]

The opinion also anticipated the criticism that "dismissal with prejudice is too severe a sanction for what might be an irrelevancy added to the complaint out of an anxious desire to leave no stone unturned."[216] The court responded that lawyers filing fraud claims have the responsibility to know about, and comply with, the preclusive mandate of the Uniform Standards Act.[217] The court noted that if an attorney added the misrepresentation or omission allegations, he "must have thought the allegations added *something* to his case."[218] If dismissal with leave to amend were permitted, the court conceived that "maybe the state court will allow" the litigants to reintroduce the fraud allegations, thereby permitting "state-court end runs around [the] limitations [of] the [Reform Act]."[219] Thus, the Seventh Circuit disposed of the Intermediate Approach.

Because the court declined to explicitly adopt either the Literalist or the *La Sala* Approach, it engaged in analysis of the potential success of the plaintiffs' breach of loyalty claim absent the allegations of fraud.[220] The court reasoned that "[t]he allegation of fraud would be *difficult* and *maybe impossible* to disentangle from the charge of breach of the duty of loyalty that the defendants owed their investors."[221] Disclosures regarding the Advisors' potential conflict of interest, even if "full and accurate," would still fail to defeat "a claim of breach of the duty of loyalty because that duty is not dissolved by disclosure."[222] The problem being that, although such a breach of loyalty could be maintained, "it would have to be brought as a derivative suit."[223] In other words, it was not that the plaintiffs' claims of fraud were necessary to their claim for breach of loyalty, but that those claims were necessary to bringing a direct, as opposed to derivative, suit.[224]

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214. *Id.*
215. *Id.*
216. *Id.*
217. *Id.*
218. *Id.*
219. *Id.*
220. *Id.* at 128-30.
221. *Id.* at 129 (emphasis added).
222. *Id.*
223. *Id.*
224. *Id.*

The Uniform Standards Act does not bar derivative suits.[225] In fact, the *Brown* plaintiffs originally had the option of initiating such a suit instead of their state-law claim class action; however the Seventh Circuit's dismissal with prejudice eliminated the opportunity to do so.[226] Judge Posner offered an explanation for the suit not being filed as derivate in the first place, however, and those reasons are fairly compelling.[227] Before the plaintiffs could file a derivative suit, "[c]ounsel would be required to demand that the corporation's board authorize suit."[228] Most likely, the board would "form a special litigation committee that after considering the question would decide that a suit was not in the corporation's best interest."[229] If plaintiffs did bring a derivative suit, not only would it be exempt from the Uniform Standards Act because of the exception for derivative suits, but it also would be exempt because the derivative action would not require that the plaintiffs allege fraud.[230] A derivative action would be based on the argument "that the executives had hurt the fund itself by reducing its profitability in order to shore up the profitability of other funds in which they had interests."[231] The requirement for board approval of a derivative claim, however, results in the corporation being able to use fund assets, which are also the shareholder assets, to form a committee to argue against shareholder recovery.[232]

Ultimately, the Seventh Circuit concluded that the suit could not survive as a direct suit without the allegations of fraud.[233] Without the allegations of fraud, the plaintiffs would be left claiming merely that the defendants breached their fiduciary duty of loyalty when they financially benefitted from their decision to redeem the preferred stock.[234] Ultimately, "the fact that management profits from an increase in the size of its enterprise is not a breach of its duty of loyalty to shareholders."[235] As a result, the court reasoned that the case was barred by the Uniform Standards Act under both the Literalist and *La Sala* Approaches, because absent allegations of fraud, plaintiffs' claims "*might* not be plausible."[236]

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225. 15 U.S.C. § 78bb(f)(1) (2012).
226. *Brown*, 664 F.3d at 129.
227. *Id.*
228. *Id.*
229. *Id.*
230. *Id.*
231. *Id.*
232. *See* FED. R. CIV. P. 23.1.
233. *Brown*, 664 F.3d at 129-30.
234. *Id.* at 130.
235. *Id.*
236. *Id.* (emphasis added).

The court further buttressed its decision to dismiss with prejudice by noting that the "forum manipulation" rule demanded it.[237] The rule, recognized by the Supreme Court in *Rockwell Int'l Corp. v. United States*, is triggered when a plaintiff attempts "to prevent the defendant from defending in the court that obtained jurisdiction of the case on his initiative."[238] The court did not explicitly state how this rule applied in this case, other than to characterize any potential re-filing in state court by the plaintiffs as "pulling the rug out from under your adversary's feet."[239] Presumably, the defendants' initiation of the removal to federal court meant that any re-filing in state court would be contrary to the defendants' intention, even though purely state-law claims barred by the Uniform Standards Act may lack jurisdiction in the defendants' choice of forum.

*3. Not So Fast: A Critical Examination of the Seventh Circuit's Analysis*

In its decision to reject the Intermediate Approach, the Seventh Circuit missed the mark. Particularly, in support of the decision to dismiss *Brown* with prejudice, the court returned repeatedly to the flawed argument that state courts cannot be trusted to prevent allegations of fraud from reentering the suit.[240] The court further supported the decision to dismiss with prejudice by expressing doubt as to the credibility of an attorney's attempt to extract the allegations of fraud.[241] Effectively, such a concern holds securities litigators to a higher pleading standard than attorneys practicing in other, often far less complicated, fields of law. The forum manipulation concerns espoused by the court were also unmerited, as those concerns ignore the fact that the Uniform Standards Act itself is the antidote to forum manipulation. In reality, the best way to respect the Supreme Court and congressional mandate to broadly interpret the Act, while preserving the cases specifically omitted from the Act, is to apply a broad interpretation of alleging fraud or misrepresentation but to dismiss barred suits with leave to re-file amended complaints in state court.

*a) Rejecting the "Inadequate Discipline of State Courts" Argument*

The court's concerns about state courts' capacity are disturbing. As a policy matter, our federal justice system should not rest on the justification that state court judges are incompetent. At the heart of the Seventh Circuit's

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237. *Id.* at 131.
238. *Id.* (citing Rockwell Int'l Corp. v. United States, 549 U.S. 457, 474 n.6 (2007)).
239. *Id.*
240. *See id.* at 128, 131.
241. *Id.* at 128.

concern was that state courts would be unable to control the scope of the suit and might allow re-introduction of the fraud allegations down the road.[242] Even if the scope of the litigation is not strictly controlled by the complaint, as alleged by the Seventh Circuit, a state-court judge should have the power to restrict introduction of evidence of fraud.[243]

An allegation asserted in the post-complaint stage of litigation would not require removal merely for its assertion. At that point the judge could simply deny its admission and limit the claim to the boundaries of the complaint, thereby removing any concerns of Uniform Standards Act preclusion. Moreover, even if a state-court judge wrongfully admits an allegation of fraud or misrepresentation, it is almost incomprehensible that defendant's counsel would allow such an allegation to slip into litigation at any stage. The defendant's counsel would almost certainly be on-guard for any such attempts, particularly after a successful dismissal in federal court based on such allegations. This is not to say that it should be the defendant counsel's duty to ensure that the complaint complies with the Uniform Standards Act; it is simply to say that if a state-court judge either failed to recognize or permitted reinsertion of a claim of fraud, the defendant's counsel would surely serve as a backstop.

Even if the state court allowed allegations of fraud to permeate the suit after the complaint stage, this worst-case scenario is still better than dismissing suits that are likely meritorious, nonstrike suit cases. This is best shown through example. Let us assume that the *Brown* plaintiffs successfully re-file their complaint in state court without any allegations of fraud or misrepresentation. If the claim is unable to survive a motion to dismiss absent the allegations of fraud, then dismissal with prejudice will be appropriate at that time. At least by then the plaintiffs will have had the opportunity to amend their complaint to attempt to allege the breach of state law as they originally intended.

Continuing with the example, in Judge Posner's worst-case scenario the plaintiffs would survive a motion to dismiss after removing the allegations of fraud and then, down the line, reinsert allegations of fraud.[244] In this scenario, however, the plaintiffs will have established that their claim is not predicated on allegations of fraud by surviving the motion to dismiss. In other words, the plaintiffs will have shown that their claims can survive wholly without the allegations of fraud or misrepresentation and that the underlying state-law

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242. *Id.* at 127.

243. *See, e.g.*, People v. Illgen, 583 N.E.2d 515, 519 (Ill. 1991) ("The admissibility of evidence at trial is a matter within the sound discretion of the trial court . . . .").

244. *Brown*, 664 F.3d at 127.

claim is almost certainly not the strike suit the Reform Act was designed to eliminate. Instead, such claims are most likely meritorious state-law claims, perhaps even fiduciary duty claims such as those in *Brown*. These fiduciary duty claims provide an essential check on corporations and businesses,[245] and congressional intent that not all state-law corporate law class actions should be precluded by the Uniform Standards Act is supported by the fact that the Act itself does not bar all state-law securities class actions.[246]

*b) Rejecting the "Attorneys Should Know Better" Argument*

Dismissal without leave to amend is also not justified by the argument that attorneys filing securities claims should be familiar with the contours of the Uniform Standards Act. In theory, we hope that all attorneys are well versed in the laws surrounding a suit they file. Nonetheless, the Federal Rules of Civil Procedure create multiple opportunities for amendment, without stating that attorneys should have known that their client's claim was subject to a motion to dismiss.[247] Mandating that a litigator in the securities field, or even a corporate lawyer bringing a suit that includes securities, shall not be given an opportunity to revise their complaint would essentially hold securities attorneys to higher standards than those practicing in other areas of law.

Moreover, the application of the Uniform Standards Act is not as easily navigated or clearly established as Judge Posner indicates, as represented by his own reference to the circuit split regarding when a complaint has alleged fraud or misrepresentation.[248] Even after *Brown*, plaintiffs' attorneys cannot predict whether the pleadings will be held to the standard of the entirely distinct Literalist or *La Sala* Approaches.[249] At the very least, they should be permitted to amend if they guess incorrectly.

245. *Cf.* Lisa L. Casey, *Twenty-Eight Words: Enforcing Corporate Fiduciary Duties Through Criminal Prosecution of Honest Services Fraud*, 35 DEL. J. CORP. L. 1, 12 (2010) ("Universally, as in Delaware, directors and officers owe fiduciary duties to their firms in order to discipline managers' self-interested conduct.").

246. *See* 15 U.S.C. § 78bb(f)(5)(B)(i) (2012) (excluding class actions with fewer than fifty members from Uniform Standards Act preclusion); *see also* 6 JEFFREY B. MALETTA & NICHOLAS G. TERRIS, BUSINESS AND COMMERCIAL LITIGATION IN FEDERAL COURTS § 68:38 (Robert L. Haig ed., 3d ed. 2012) ("[The Uniform Standards Act] does not reach all class actions involving securities under state law.").

247. FED. R. CIV. P. 15.

248. *See supra* Part III.

249. *Brown*, 664 F.3d at 130 (holding that the "suit is therefore barred by [the Uniform Standards Act] under any reasonable standard" without explicitly choosing which standard to apply).

### *c) Rejecting the "Forum-Manipulation Rule" Argument*

Finally, the forum-manipulation rule should be inapplicable to state-court claims removed to federal court based purely on Uniform Standards Act preclusion. In *Rockwell*, the Supreme Court supported the forum-manipulation rule in a footnote.[250] It mentioned that "when a defendant removes a case to federal court based on the presence of a federal claim," if the plaintiff amends their complaint "eliminating the original basis for federal jurisdiction," the federal court's subject-matter jurisdiction typically remains intact.[251] This stands in contrast to the situation in which a plaintiff originally filed a complaint in federal court and subsequently amended the complaint to remove the basis for federal jurisdiction because "removal cases raise forum-manipulation concerns that simply do not exist when it is the *plaintiff* who chooses a federal forum."[252]

Like in *Brown*, it is quite possible that in Uniform Standards Act preclusion cases the only ground for federal jurisdiction will be Uniform Standards Act preclusion.[253] Even if the defendant wanted to adjudicate the case in federal court, if the only ground for removal is Uniform Standards Act preclusion, then once the claim avoids or succumbs to the preclusion, federal courts no longer have subject-matter jurisdiction. Any subsequent re-filing of the claim in state court once the allegations of fraud had been removed would not be for the purpose of preventing the defendant from litigating in the forum of his choice. The re-filing necessarily must be in state court because the federal courts lack jurisdiction over the claim. After all, "[f]ederal courts are courts of limited jurisdiction."[254] Because re-filing in state court would be required for jurisdictional reasons, the "forum manipulation" rule has no place in the context of the Uniform Standards Act preclusion.

### *d) Drawing Attention to Importance of the Uniform Standards Act's Statutory Exceptions*

Many of the concerns addressed so far can be traced to a misunderstanding of the nature of the Uniform Standards Act itself. As explained in Part III, the Uniform Standards Act was designed to be the antidote to the shift in class-

250. Rockwell Int'l Corp. v. United States, 549 U.S. 457, 474 n.6 (2007).
251. *Id.*
252. *Id.*
253. *See* Notice of Removal at 3-7, Brown v. Calamos, 777 F. Supp. 2d 1128 (N.D. Ill. 2011) (No. 1:10-cv-06558), 2010 WL 4236606.
254. Kokkonen v. Guardian Life Ins. Co. of Am., 511 U.S. 375, 377 (1994).

action securities filings to state rather than federal court.[255] In designing this antidote, the drafters decided to leave some state authority unhindered.[256]

In fact, the Uniform Standards Act provides exceptions from its preclusion to "certain class actions based on the law of the State in which the issuer of the covered security is incorporated, actions brought by a state agency or state pension plan, actions under contracts between issuers and indenture trustees, and *derivative actions* brought by shareholders on behalf of a corporation."[257] When plaintiffs amend their complaint to meet one of these exceptions, they have modified their claim to fall within the carve-outs specifically permitted by Congress. In other words, courts should not consider plaintiffs to have engaged in strategic evasion of the Reform Act when they amend their complaint *in substance* to avoid Uniform Standards Act preclusion.

The Seventh Circuit specifically has recognized that leave to amend should be denied "only if it appears to a certainty that the plaintiff cannot state a claim upon which relief can be granted."[258] In *Brown*, it was not established with certainty that the plaintiffs could not extract their allegations of fraud from their state-law claims. The court hypothesized that it "would be *difficult* and *maybe impossible*" to eliminate the allegations of fraud and successfully plead breach of the duty of loyalty.[259] Most notably in its holding, the Seventh Circuit wrote that absent allegations of fraud, plaintiffs' claims "*might* not be plausible."[260] These observations fall short of certainty. In fact, the opinion expressly admitted that if the case were dismissed without prejudice, plaintiffs could have "refiled as a derivate suit."[261] In other words, the court admitted that the plaintiffs in *Brown* may have been the victims of a cognizable injury for which the law provides a remedy. Even in light of this, the Seventh Circuit was unwilling to dismiss without prejudice. Such a disposition smacks of vindictiveness for the perceived abuses by those who preceded these plaintiffs, not adherence to broad interpretation of the Uniform Standards Act or any of the other reasons cited by the court in *Brown*.

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255. *See supra* Part III.C-D.

256. *See* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 87-88 (2006) (citing 15 U.S.C. §§ 78bb(f)(3)(A)-(C), (f)(5)(C)).

257. *Id.* (citing 15 U.S.C. §§ 78bb(f)(3)(A)-(C), (f)(5)(C)) (emphasis added).

258. Rohler v. TRW, Inc., 576 F.2d 1260, 1266 (7th Cir. 1978); *see also* Barry Aviation Inc. v. Land O'Lakes Mun. Airport Comm'n, 377 F.3d 682, 687 n.3 (7th Cir. 2004).

259. Brown v. Calamos, 664 F.3d 123, 129 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012) (emphasis added).

260. *Id.* at 130 (emphasis added).

261. *Id.* at 129.

It seems directly contrary to the statute to dismiss with prejudice a claim that could be filed as a derivative action. A broad interpretation of the Act is essential, in fact mandated, to ensure that its remedial purpose is not circumvented by artful pleading. Not all amendments, however, would necessarily amount to attempting to hide the substance of the claim. For example, allowing a suit without allegations of fraud to proceed would not amount to valuing substance over form. Similarly, a class action meeting all other requirements but with less than fifty members would not fall under the preclusion. Given the mandatory broad interpretation of the Act, it is necessary to give weight both to the exceptions to the statute as well as the preclusions.

*4. Potential Consequences of* Brown*: Cognizable State Legal Claims Denied a Remedy by the Federal Government*

*Brown* is already being cited for the proposition that federal courts should dismiss with prejudice suits precluded by the Uniform Standards Act.[262] Such a blanket categorization of the holding in *Brown* may prove imminently dangerous to meritorious claims caught in the Uniform Standards Act's net. This danger reaches beyond traditional securities law into traditional state law, like corporate fiduciary duty liability, that may happen to touch securities. In *Dabit*, the Supreme Court dismissed breach of contract and fiduciary duty claims with prejudice in part because state law had not been the traditional "vehicle for asserting class-action securities fraud claims."[263] While that statement is in fact correct, it is only one way of looking at the issue. Although class-action securities fraud claims were not traditionally brought in state court, corporate fiduciary duty claims certainly have been.[264] It is much like the assertion made by securities law reform advocates that class actions were not contemplated by the drafters of the Securities Act of

262. *See, e.g.*, DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 2:2 n.64 (2012) (characterizing *Brown* as "noting that deletion of fraud claim would lack credibility, given facts alleged in complaint and might open gate to forum manipulation"); 1 JOSEPH M. MCLAUGHLIN, MCLAUGHLIN ON CLASS ACTIONS § 2.44 n.7 (9th ed. 2012) (citing *Brown* for the proposition that suits preempted by the Uniform Standards Act should be dismissed with prejudice).

263. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 88 (2006).

264. *Cf.* Jeffrey Baddeley, *Defending Directors and Officers Against Breach of Fiduciary Duty Claims in Bankruptcy*, BLOOMBERG LAW (2012), http://about.bloomberglaw.com/practitioner-contributions/defending-directors-and-officers-against-breach-of-fiduciary-duty-claims-in-bankruptcy/ ("Delaware courts have identified three categories of bad faith corporate fiduciary conduct . . . .").

1933 and the Exchange Act of 1934.[265] Again, this is true, but it disregards the fact that the engineers of the class-action device certainly contemplated, in fact emphasized, the application of the class-action device to securities fraud.[266] Much the same way, even though securities class actions have not traditionally found their forum in state court, fiduciary duty class actions traditionally have.[267]

In *Brown*, the plaintiffs brought a state-law breach of fiduciary duty claim.[268] They should have been permitted at least one opportunity post-removal to delete the allegations of fraud and pursue their claim, which was ultimately an issue of state law, in state court. It does not make sense to require federal appellate courts to make searching inquiries into whether the claim would be dismissed at the state court level without the assertions of fraud. That is a decision for state courts. Similarly, if courts adopt the reasoning of the Seventh Circuit, many injured investors could be denied relief, just as the plaintiffs were in *Brown*. State fiduciary duty laws are intended to deter fraud and self-dealing by directors, but when the Uniform Standards Act is improperly applied, the result may be to prevent those liability laws from serving their purpose.[269]

## *V. Conclusion*

The superior approach to Uniform Standards Act preclusion analysis would be to respect the broad sweep of the statute created by Congress while permitting the opportunity to amend the claim at least once. As such, the Seventh Circuit should not have dismissed *Brown* with prejudice or categorically implied that all cases precluded by the Uniform Standards Act should be dismissed with prejudice. Although the court conducted an in-depth fact analysis to determine whether the claim could survive without the allegations of fraud, which could be interpreted to suggest that determinations to dismiss with or without prejudice should be made on a case-by-case basis, the remainder of the opinion disposes of that option.

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265. Perino, *supra* note 21, at 283.

266. YEAZELL, *supra* note 33, at 232 (citing Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684 (1941)).

267. *See* Casey, *supra* note 245, at 9 ("This part identifies the significant legal obstacles preventing shareholders from enforcing management's fiduciary duties in state court or federal court, whether shareholders bring their claims derivatively or as class actions.")

268. Brown v. Calamos, 664 F.3d 123, 125 (7th Cir. 2011), *cert. denied*, 132 S. Ct. 2774 (2012).

269. *See* Casey, *supra* note 245, at 17.

By dismissing cases with prejudice in federal court because a federal judge is not certain that the plaintiffs could amend their complaint to remove the allegations of fraud from their state-law claim, the plaintiffs and the state court are denied the opportunity to work within the bounds of state law. The state court is denied the opportunity to interpret and apply state law. The plaintiffs are denied the opportunity to access the state courthouse in the most cost-effective form of suit, the class action. Originally, the plaintiffs remained free to sue in state court with a class of less than fifty people or to bring the action in federal court and meet the high pleading requirements of the Reform Act. A dismissal with prejudice, however, eliminates those opportunities for the aggrieved plaintiffs, and as a result, corporate fraud may go undeterred.

*Selby P. Brown*