IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

JOSEPH AVENIUS,

Plaintiff,

v.

BANC OF AMERICA SECURITIES LLC,

Defendant.
_____/

No. C06-04458 MJJ

ORDER GRANTING MOTION TO REMAND PURSUANT TO 28 U.S.C. § 1447(c)

INTRODUCTION

Before the Court is Plaintiffs' Motion to Remand Pursuant to 28 U.S.C. § 144(c). (Doc. # 31.) Defendants filed an Opposition (Doc. # 46), and Plaintiffs filed a Reply thereto. (Doc. # 50.)

For the following reasons, the Court **GRANTS** the Motion.

FACTUAL BACKGROUND

This case arises from Defendants' purported illegal stock market manipulation scheme, which Plaintiffs claim affected the price of shares in Novastar Financial, Inc. ("NFI"), a stock which Plaintiffs owned. The material allegations, taken from Plaintiffs' Complaint, are as follows.

Plaintiffs were all at some point owners of NFI common stock. Defendants are business entities engaged in the prime brokerage business. (Complaint ¶54.) As prime brokers, Defendants are responsible for assuring the proper accounting and settlement of stock trades, including short sales. As Plaintiffs describe, a short sale is when "a person sells stock that he or she does not then own, by borrowing the stock and warranting to the stock lender that the loan will be 'covered' with

shares purchased at a later date. The seller speculates that the price of the stock will go down so that, when the loan is 'covered,' he or she will profit from the drop in price." (*Id.* ¶56.) In particular, in the short sale context, prime brokers are responsible for locating shares of the shorted stock, borrowing the stock, and delivering the stock to the buyer for a fee paid by the short seller. (*Id.* ¶57, ¶59.) According to Plaintiffs, "[p]rime brokers are required to deliver the stock within three days of the short sale. If the prime broker fails to deliver the security to the buyer within the normal three day settlement period, the shares become 'fails to deliver' and the sale is a 'naked short sale.'" (*Id.* ¶60.)

Further, Plaintiffs allege that "[p]rime brokers are motivated to intentionally fail to deliver stocks because this removes a core cost from their securities lending business - the cost of providing the security, thus allowing them to earn more money through the charging of fees, commissions and/or interest through phantom securities transactions." (*Id.* ¶62.)

A persistent large number of fails to deliver create immense downward pressure on the price of a company's stock. (*Id.* ¶63.) Plaintiffs allege that, beginning in January 2005, large quantities of NFI stock were not properly delivered for settlements. Plaintiffs further allege that "Defendants, who control 83% of the prime brokerage market, have at all times alleged herein and continue to, intentionally fail to deliver NFI stock to buyers in short sales transactions," thereby creating "dramatic distortions with regard to the nature and amount of trading in NFI's publicly held stock." (*Id.* ¶67, ¶68.) As a result, Plaintiffs charge that "NFI's share price is depressed because of the oversupply caused by failing to settle transactions with shares issued by NFI," and that "[s]hares issued by NFI . . . are not being properly valued because of the dilutive effect of the phantom shares, which were not issued by NFI." Defendants' purported acts resulted in (1) the loss of the price per share of NFI common stock, which has declined by more than 50%; and (2) an impairment of NFI's share price continued ability to grow at historic rates. (*Id.* ¶72.) Additionally, Plaintiffs allege that they each incurred damages, in that, each of them "sold shares of NFI during the timeframes alleged [] that Defendants acted wrongfully at prices that were artificially depressed due to Defendants wrongful conduct." (*Id.* ¶73.)

Plaintiffs contend that Defendants' wrongful conduct took place either directly or indirectly

in the State of California. (*Id.* ¶ 70, ¶ 75.)

Based on the foregoing allegations, Plaintiffs assert claims against Defendants for: (1) market manipulation in violation of California Corporations Code §§ 25400 et seq.; and (2) unfair business practices in violation of California Business & Professions Code §§ 17200 and 17500.

On July 21, 2006, Defendants removed this matter to Federal Court. (Doc. # 31.) Defendants assert that this Court has original jurisdiction of this action under 28 U.S.C. § 1331 because it arises under the laws of the United States. Defendants contend that Plaintiffs claims depend on the interpretation and resolution of federal securities law and regulations promulgated thereunder by the United States Securities Exchange Commission ("SEC"). (Notice of Removal at ¶ 3.) More specifically, Defendants alleged that Plaintiffs claims are premised on failures to deliver stock in connection with short sales, and such practices are directly addressed by the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a, et seq., (the "Exchange Act"), and/or the rules and regulations the SEC promulgates thereunder. The delivery requirements flow from the Exchange Act, and "failures to deliver are closely regulated under the Exchange Act's provision, Including Regulation SHO." (*Id.* at ¶ 4.)

Defendants also contend that this Court has diversity jurisdiction over this matter notwithstanding the fact that three of the Plaintiffs are citizens of the same state as several Defendants. Asserting fraudulent joinder, Defendants urge this Court to disregard the citizenship of the non-diverse plaintiffs because they cannot establish liability against any Defendant. (*Id.* at ¶ 7.)

On August 14, 2006, Plaintiffs filed their Motion to Remand.

LEGAL STANDARD

Pursuant to 28 U.S.C. § 1441(a), a defendant in a civil action may remove a case from state court to federal district court if the district court has subject matter jurisdiction over the case. The district court has subject matter jurisdiction if there is diversity of citizenship between the parties, or if the action is founded on a claim arising under the Constitution, laws, or treaties of the United States. 28 U.S.C. § 1441(b); 28 U.S.C. § 1331 (federal question); 28 U.S.C. § 1332 (diversity jurisdiction); *Ethridge v. Habor House Restaurant*, 861 F.2d 1389, 1393 (9th Cir. 1988). As the

party seeking to remove the action, the defendant bears the burden of establishing that subject matter jurisdiction exists. *Id.* at 1393. Because the Court strictly construes the removal statute against removal, if there is any doubt as to the existence of federal jurisdiction, the Court should remand the matter to state court. See *Gaus v. Miles*, Inc., 980 F.2d 564, 566 (9th Cir. 1992).

ANALYSIS

I. Federal Question Jurisdiction, 28 U.S.C. § 1331

Defendants, contend that this Court has original jurisdiction over this action under 28 U.S.C. § 1331 because it arises under the laws of the United States. "The presence or absence of federal question jurisdiction is governed by the 'well-pleaded complaint rule,' which provides that federal jurisdiction exists only when a federal question is presented on the face of the plaintiff's properly pleaded complaint." *Caterpillar, Inc. v. Williams*, 482 U.S. 386, 392 (1987). An action raising a defense based on federal law does not create federal question jurisdiction "even if the defense is anticipated in the plaintiff's complaint, and even if both parties admit that the defense is the only question truly at issue in the case." *Franchise Tax Bd. of Cal. v. Constr. Laborers Vacation Trust*, 463 U.S. 1, 14 (1983). Plaintiff "is master of . . . her complaint and may avoid federal jurisdiction by exclusive reliance on state law." *Easton v. Crossland Mortgage Corp.*, 114 F. 3d 979, 982 (9th Cir. 1997). However, "a plaintiff may not avoid federal jurisdiction by omitting from the complaint federal law essential to his or her claim or by casting in state law terms a claim that can be made only under federal law." *Id.*

A. The Face of the Complaint

Generally, federal jurisdiction must appear on the face of plaintiff's properly-pleaded complaint. See *Caterpillar*, 482 U.S. at 392. Here, it is undisputed that Plaintiffs' Complaint asserts two claims arising under California's statutory law. Thus, there is no federal question presented on the face of Plaintiffs' complaint.

B. The Artful Pleading Doctrine

The Court's inquiry, however, does not end there. Defendants contend that, despite the absence of a federal question on the face of the Complaint, federal question jurisdiction exists because "Plaintiffs' claims depend on resolution of a substantial question of federal law - whether

the purported failures to 'locate,' 'borrow,' and 'deliver' violated Defendants' obligations arising under the SEC's Regulation SHO and the predecessor SRO rules governing short selling." As such, Defendants maintain that the district court has exclusive jurisdiction over Plaintiffs' claims under Section 27 of the Exchange Act, 15 U.S.C. § 78aa, which states:

> The district courts of the United States and the United States Court of any territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter, or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter, or the rules and regulations thereunder.

Plaintiffs counter that they do not assert, rely on, or attempt to enforce any such laws or regulations; instead, "Plaintiffs will be asking the jury to find that Defendants' intentional failures to deliver NFI stock resulted in manipulation of the market as defined in California's securities statutes, and that such actions by Defendants amounted to unfair business practices as such practices are defined under California's UCL." Because they do not seek to enforce any right or liability created by the Exchange Act, Plaintiffs argue that their claims fall within 15 U.S.C. §78bb, which preserves both common law and state authority over securities matters. *See Matsushita Elec. v. Indus. Co.* v. *Epstein*, 516 U.S. 367, 383 (1996).

The Court must determine whether Plaintiffs have artfully plead claims that, although couched in terms of state law, necessarily arise under federal law. *See Franchise Tax Bd., 463 U.S.* at 22. The artful pleading doctrine prevents a plaintiff from avoiding federal jurisdiction "by omitting from the complaint federal law essential to his or her claim or by casting in state law terms a claim that can be made only under federal law." *Easton*, 114 F. 3d at 982. This Court may re-characterize such "artfully pleaded" state law claims as federal claims. *See Lippitt v. Raymond James Financial Svcs. Inc.*, 340 F. 3d 1033, 1041 (9th Cir. 2003).[1] A state claim can be deemed to arise under federal law where the right to relief depends on the resolution of a substantial, disputed federal question. *See ARCO Envtl. Remediation, LLC v. Dep't of Health and Envtl. Quality of the State of Montana*, 213 F. 3d 1108, 1114 (9th Cir. 2000), *Grable & Sons Metal Products v. Darue*

[1]However, the Ninth Circuit has called the doctrine a "minefield" and cautioned that "[c]ourts should invoke the doctrine only in limited circumstances as it raises difficult issues of state and federal relationships and often yields unsatisfactory results." *Lippett*, 340 F 3d at 1041.

Eng'g & Mfg., 125 S. Ct. 2363, 2367 (2005).

For example, in *Sparta Surgical Court v. NASD*, 159 F. 3d 1209 (9th Cir. 1988), the plaintiff filed suit in state court alleging various state law claims after defendant temporarily de-listed and suspended trading of the plaintiff's stock on the opening day of a public offering. *Id.* at 1210-1211. The defendants removed to federal court, and the Ninth Circuit held that the district court properly denied the plaintiff's motion to remand. *Id.* at 1211. Because the viability of any cause of action founded upon NASD's conduct in de-listing the stock or suspending trading depended on whether NASD followed its own rules, the federal court had jurisdiction to enforce such rights or liabilities created by the Exchange Act. *Id.* at 1212.

Similarly, in *D'Alessio v. NYSE*, 258 F. 3d 93 (9th Cir. 2001), the court found that, although the plaintiff plead only state law claims, the gravaman of the complaint was that the defendant conspired to violate federal securities laws and rules, and failed to perform its statutory duty – created by federal law – to enforce its members' compliance with those laws. *Id.* at 101-102. Since the defendant's violations of federal law and its improper interpretation of federal law formed the basis for the plaintiff's claims, the federal question was substantial enough to confer federal question jurisdiction. *Id.* at 102-103.

However, "not every question of federal law emerging from a suit is proof that a federal law is the basis for the suit." *Gully v. First Nat'l Bank in Meridian*, 299 U.S. 109, 115 (1936). Even when a complaint repeatedly refers to federal law, it does not state a federal question where a plaintiff invokes an independent state law. *ARCO*, 213 F. 3d at 1113.

In *Lippitt, supra*, the plaintiff alleged a claim in state court for violation of California's Unfair Competition Law related to defendant's marketing of "callable CDs." The misconduct alleged by the plaintiff overlapped with conduct proscribed by NYSE rules, and the complaint tracked "almost verbatim the misdeeds proscribed by NYSE rules." *Lippitt*, 340 F. 3d at 1037. Nevertheless, the court held that the complaint did not raise a substantial federal question because plaintiff did not challenge any right or liability created by the Exchange Act. Rather, the plaintiff challenged the defendant's allegedly deceptive marketing practices under California law, irrespective of whether the tactics also violated federal law. *Id.* at 1044.

1. The California Corporations Code § 25400 Claim

Contrary to cases where federal jurisdiction was found to exist, Plaintiffs' Section 254000 claim does not assert a right or liability created by federal statute. In *Sparta*, federal subject matter jurisdiction existed because the disputed issue was whether the NASD had followed its own rules in delisting the plaintiff's stock; this issue was central to the proof of the plaintiff's claims. *Sparta* 159 F. 3d at 1209. In other words, since the *only* basis for the plaintiffs claims was NASD's rules and regulations, a substantial federal question existed. *Lippitt*, 340 F. 3d at 1044 (interpreting *Sparta*). In *D'Allesio*, the plaintiff's claim turned on a finding that the NYSE failed to enforce duties *created by* federal law. *D'Allesio*, 258 F. 3d at 93; *Lippit* 340 F. 3d. at 1045 (interpreting *D'Allesio*).

Here, Plaintiffs assert, *inter alia*, that Defendants never intended to make a timely delivery of the stock, and therefore, they engaged in deceptive conduct. As importantly, Plaintiffs argue that there is no substantial disputed question of federal law because there is no dispute as to the time frame, set forth in the federal regulations, for delivery. Unlike *Sparta* or *D'Alessio*, the central issue is not whether Defendants complied with the federal rules or regulations. Rather, Defendants' intent with respect to delivery is central to the proof of Plaintiffs' claims. In that regard, the duty or liability is not created by federal law; rather it is created by state statute. Nor is a substantial disputed question of federal law a necessary element of the Section 25400 claim. *See ARCO*, 213 F. 3d at 1116. Accordingly, this matter is more like *Lippit*, wherein the challenge to defendants' marketing practices were the gravaman of the plaintiff's complaint, irrespective of whether the tactics also violated federal law.[2]

For these reasons, the Court finds that the Section 25400 claim does raise a substantial federal question.

2. The Unfair Competition Law Claim

California's Unfair Competition Law ("UCL") establishes three types of unfair competition – unlawful, unfair, or fraudulent acts or practices. *Cel-tech Communications, Inc. v. Los Angeles Telephone Co.*, 20 Cal.4th 163, 180 (1999). Plaintiffs argue that their UCL claim does not depend

[2]That Defendants may try to argue in their defense that there was no wrongdoing because their actions were consistent with federal law does not create federal question jurisdiction. *See Franchise Tax Bd. of Cal.*, 463 U.S. at 14.

on a finding that Defendants violated federal securities laws, rules, or regulations because they can prove this claim by showing that Defendants acted unfairly or fraudulently. Citing *California ex rel. Lockyer v. Dynergy, Inc.*, 375 F. 3d 831 (9th Cir. 2004), Defendants argue that regardless of particular prong of § 17200 at issue, federal law governs the propriety of Defendants' conduct. Thus, this claim turns on a substantial issue of federal law, and the Court has removal jurisdiction.

In *Dynergy*, the plaintiff filed a UCL claim in state court predicated solely on the defendants' failure to comply with a tariff filed pursuant to the Federal Power Act ("FPA"). Because, the viability of the claim depended entirely on a violation of the tariff, the district court had removal jurisdiction under 16 U.S.C. § 825p of the FPA, which affords the district courts exclusive jurisdiction over violations or suits brought to enforce any right or liability created by the FPA. *Id.* at 840-841. The court also stated, without explanation, that whether the defendants' practices were unfair or fraudulent also depended entirely on the tariff. *Id.* at 841, n.6.

Dynergy is distinguishable from this matter. Here, Plaintiff's UCL claim is not predicated solely on a violation of federal law. Indeed, the "unlawful" prong of Plaintiff's UCL claim may be predicated on a violation of California Corporations Code § 25400, which plaintiffs also allege. As described above, unlawful conduct in violation of § 25400 does not hinge on a violation of federal law. In addition, because Plaintiff's claims are not predicated entirely on rights or obligations created by federal law, a court need not refer only to federal law to determine whether Defendants' conduct was unfair or fraudulent. As such, the Court finds that Plaintiff UCL claim does not raise a substantial federal question.[3]

In light of the above, the Court does not have federal question jurisdiction under 28 U.S.C. § 1331.

II. Diversity Jurisdiction

[3]The present case is similar to *California ex rel. Lockyer v. Powerex Corp.*, 2005 WL 2030718 (E.D. Cal.). There, plaintiff filed a UCL claim alleging that defendant engaged in unlawful, unfair, and fraudulent tactics in the provision of electricity. *Id.* at *1. Plaintiff predicated its UCL claim on violations of the California Corporations Code and California Commodity law. *Id.* at *2. The court distinguished *Dynergy* and remanded the case, holding that plaintiff did not seek to enforce any liability or duty created by the FPA, and plaintiff alleged that it could prove violations of the California statutes without resort to federal law. *Id.* at *7. That is exactly the situation here.

Alternatively, Defendants assert that removal to district court is proper because diversity jurisdiction exists in this matter. Recognizing that at least three of the named Plaintiffs are citizens of New York (the "New York Plaintiffs"), Defendants argue that, "because there is no possibility that these non-California Plaintiffs will be able to establish liability against any Defendant," they have been fraudulently joined. As such, Defendants urge the Court to disregard the New York Plaintiffs for purposes of determining jurisdiction.

Plaintiffs contend that Defendants have not fulfilled the heavy burden of persuasion to justify a finding of fraudulent joinder, and assert that the New York Plaintiffs have sufficiently alleged that the conduct at issue occurred in California. Namely, paragraph 70 Plaintiffs' Complaint alleges: "Upon information and belief, Defendants' market manipulation took place in the state of California." Additionally, Plaintiffs point to paragraph 75 of their Complaint, which alleges, in pertinent part, that "Defendants' violations were committed either directly or indirectly within California."

Federal diversity jurisdiction under 28 U.S.C. § 1332(a) requires that all defendants be diverse from all plaintiffs. *Exxon Mobile Corp. v. Allapattah Servs., Inc.*, 125 S. Ct. 2611, 2617 (2005). The court may properly disregard the citizenship of fraudulently joined parties. *McCabe v. General Foods Corp.*, 811 F. 2d 1336, 1339 (9th Cir. 1987).[4] "If a plaintiff fails to state a cause of action[,]. . . and the failure is obvious according to the well settled rules of the state, the joinder is fraudulent." *United Computer Syst., Inc. v. AT&T Corp.*, 298 F. 3d 756. The defendant must show that there is no possibility that the alleged sham party can establish a cause of action. *Good v. Prudential Ins. Co. Of Am.*, 5 F. Supp. 2d 804, 807 (N.D. Cal. 1998). The party asserting diversity jurisdiction may present facts establishing fraudulent joinder. *McCabe*, 811 F. 2d at 1340.

Defendants are correct that to state actionable claims under the relevant California statutes, the New York Plaintiffs must adequately allege that Defendants' wrongdoing occurred in California. See *Diamond Multimedia v. Sup. Ct.*, 19 Cal. 4th 1036, 1053 (1999), *Norwest Mortgage v. Sup. Ct.*, 72 Cal. App. 4th 214, 225 (1999). Defendants contend that the New York Plaintiffs have failed to

[4]The doctrine of fraudulent joinder typically applies to defendants. The parties debate at length whether the doctrine likewise applies to plaintiffs. The Court finds it unnecessary to rule on this issue.

do so because the Complaint "does not come close to alleging acts of market manipulation in California, and, instead, simply asserts upon information and belief - without any supporting factual allegations - that 'Defendants' market manipulation took place in the State of California." Defendants assert that these allegations are conclusory and inadequate.

The Court, however, disagrees. According to the "well settled rules of the state," Plaintiffs' allegations are sufficient to state claims on behalf of the New York Plaintiffs. The Complaint sets forth in detail the purported wrongful conduct and alleges that such conduct occurred in California. Absent some argument that Plaintiffs lack any basis for making such allegations, the Court finds these allegations sufficient to state a viable claim under California Corporations Code § 25400 and Business and Professions Code §17200 and § 17500. Indeed, the Court notes that Defendants could have submitted evidence showing that none of the alleged wrongdoing occurred in California, but did not. See *McCabe*, 811 F. 2d at 1340.

Accordingly, assuming *arguendo* that the doctrine of fraudulent joinder applies to Plaintiffs, the Court denies Defendants' request that the Court disregard the New York Plaintiffs for the purposes of determining whether complete diversity of citizenship exists. Because complete diversity does not exist, the Court does not have jurisdiction under 28 U.S.C. § 1332(a).

CONCLUSION

For the foregoing reasons, the Court **GRANTS** Plaintiffs' Motion for Remand.

IT IS SO ORDERED.

Dated: December 30, 2006

MARTIN J. JENKINS
UNITED STATES DISTRICT JUDGE