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PERSPECTIVE

9th Circuit puts to rest decade-old Northstar litigation

By Peter Wald and Gavin Masuda

On Oct. 23, the 9th U.S. Circuit Court of Appeals likely put to rest Northstar Financial Advisors' decade-old lawsuit against Schwab Investments, Charles Schwab Investment Management, Inc. and the trustees of the Schwab Trust. The court denied Northstar's petition for rehearing *en banc* of the Sept. 14, panel decision in *Northstar Financial Advisors v. Schwab Investments*, 2018 DJDAR 9353. That decision — the second of two recent opinions from the 9th Circuit finding state law class actions by mutual fund shareholders preempted by the Securities Litigation Uniform Standards Act of 1998 — broadly applied SLUSA preemption to limit the claims that mutual fund shareholders can bring as class actions.

Specifically, the panel held that state law class actions are barred under SLUSA where "(1) the complaint's description of a defendant's conduct involves conduct specified in SLUSA, and (2) the alleged conduct will be part of the proofs in support of the state law cause of action." The panel further clarified that while "defendant's conduct need not be an element of the state cause of action, the conduct still must be a fact on which the proof of that state cause of action depends."

In *Northstar*, plaintiff brought state-law claims for breach of contract and breach of fiduciary duty, alleging that defendants caused the Schwab Total Bond Market Fund to deviate from its investment policies by investing in an over-concentration of mortgage-backed securities. Plaintiff asserted claims on behalf of two classes of investors: those who purchased before the alleged deviation from investment policy (the "Pre-Breach Class") and those who purchased after the alleged deviation (the "Breach Class"). The panel agreed that Breach Class claims were preempted by SLUSA because, at the time members of the Breach Class purchased securities, the Fund was already in violation of its investment policy — meaning that proof of the Breach Class' claims necessarily depended on defendants' misrepresentations and omissions related to compliance with the investment policy.

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But the panel split as to the Pre-Breach Class claims. The majority held that even though Pre-Breach Class members purchased securities before the alleged deviation — meaning their purchases were made by means of then-accurate disclosures regarding fund policy — their claims were preempted because the misrepresentations and omissions alleged during the Breach Period (after their purchases) were at "the heart of the *res gestae* of" the Pre-Breach claims. *Id.* Chief Judge Sidney R. Thomas, in dissent, argued against SLUSA preemption because the Pre-Breach Class could prove breach of contract and breach of fiduciary duty without reference to misstatements or omissions during the Breach Period — and noted that "SLUSA only prohibits a claim when a misrepresentation in an *essential fact* on which the original claim depends." *Id.* (emphasis added). Chief Judge Thomas further observed that under the majority's approach, "any ordinary state law breach of contract claim would be preempted ... if the breaching party failed to disclose its breach (which would be the usual case)." *Id.*

The debate between the majority and dissent is interesting for two reasons. First, it reflects a potential circuit split regarding the breadth of SLUSA preemption. Although the majority disputed the existence of a split, it adopted the broad view — which it claimed to be consistent with circuit precedent — that claims are preempted so long as the gravamen of the complaint (or "*res gestae*" of the claims) alleges misrepresentations or omissions. *Id. (citing Freeman Invs., L.P. v. Pac. Life Ins. Co.*, 704 F.3d 1110, 1115 (9th Cir. 2013)). Chief Judge Thomas meanwhile advocated for a narrower approach to SLUSA preemption — which he described as consistent with the approaches taken by the 2nd and 3rd Circuits — where claims are preempted only when "a misrepresentation is an essential fact on which the original claim depends." *Id.*

Second, the debate reflects a fundamental disagreement about what the complaint alleged. The majority held that misrepresentations or omissions were the *res gestae* of the claims; the dissent said that allegations of misrepresentations or omissions were merely "present in the complaint." This disagreement is reminiscent of the debate seen in many federal securities class actions, where district courts must determine whether the gravamen of a complaint alleges fraud such that the heightened pleading standards of the Private Securities Litigation Reform Act ("PSLRA") apply. As securities litigators will attest, district courts can and do read complaints differently. The *Northstar* panel was no different.

It remains to be seen whether Judge Thomas' warning — that "any ordinary state law breach of contract claim [will] be preempted" — will be proven true. There are several things Northstar might have done differently to avoid preemption (such as not purport to represent the Breach Class, whose claims the panel agreed were preempted) — or at least make preemption a closer call for the panel majority. But one thing Northstar and other recent 9th Circuit cases make clear is that district courts in the 9th Circuit must read complaints holistically to determine whether the "gravamen" or "*res gestae*" of the complaint alleges misstatements or omissions that would be actionable under the federal securities laws. Because this inquiry will strike different district court judges differently, we can expect to see plaintiffs continuing their efforts to plead around SLUSA — meaning the 9th Circuit will see this issue again.

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