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V. BUSINESS

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Amy Howe
The state of Kentucky taxes municipal bonds from outside the state, while providing tax exemption for municipal bonds from within the state. Municipal bond holders George and Catherine Davis sued, claiming that the disparate treatment of in-state versus out-of-state bonds was a violation of the Dormant Commerce Clause.

Questions Presented: Whether a state violates the dormant Commerce Clause by providing an exemption from its income tax for interest income derived from bonds issued by the state and its political subdivisions, while treating interest income realized from bonds issued by other states and their political subdivisions as taxable to the same extent, and in the same manner, as interest earned on bonds issued by commercial entities, whether domestic or foreign.
the Commonwealth to tax estates, trusts, and fiduciaries, as well as corporations. KRS 141.020 requires an individual to pay state taxes upon a percentage of that person's net income. For individuals, net income is determined by making certain deductions from the individual's adjusted gross income. In turn, an individual's adjusted gross income is derived by making certain deductions from a person's gross income "as defined in Section 61 of the Internal Revenue Code." In arriving at its definition of gross income, the Internal Revenue Code specifically exempts interest earned on any state or local bond. But Kentucky law requires that "interest income derived from obligations of sister states and political subdivisions thereof" is to be included in a person's adjusted gross income. The cumulative impact of those various statutes is that Kentucky exempts from taxation interest income derived from bonds issued by the Commonwealth of Kentucky or its subdivisions but requires taxes to be paid on interest income derived from bonds issued by a sister state or its subdivisions.

In April 2003, the Davises filed a class action declaratory judgment complaint alleging that Kentucky’s decision to tax the income earned on out-of-state bonds in this manner violates the Commerce Clause of the United States Constitution and the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. To attempt to demonstrate standing, the Davises alleged in their complaint that they were residents of Jefferson County who had paid Kentucky income tax on the income they earned from out-of-state bonds.

In July 2003, before the Davises had filed a motion for class certification, the Department filed a motion for summary judgment arguing that the tax system in issue was constitutional and that, furthermore, the Davises lacked standing to challenge the tax provisions applicable to corporations, estates, and trusts. In August 2004, the Jefferson Circuit Court granted the Department's motion for summary judgment on both the constitutionality of the bond taxation system and the question of the Davises' standing. The Davises filed this appeal.

III. ANALYSIS

The Davises' appeal presents two issues. First, did the trial court correctly grant summary judgment to the Department on the Davises' claim that Kentucky's system of taxing only out-of-state bonds is unconstitutional? Second, did the trial court correctly find that the Davises lacked standing to assert claims on behalf of corporations, trusts, estates, and all other non-individual plaintiffs? Following a recitation of the applicable standards of review, each question will be addressed separately.

A. Standard of Review

Summary judgment is appropriate only if the Department showed that the Davises "could not prevail under any circumstances." In ruling on a motion for summary judgment, we must view the evidence in the light most favorable to the Davises. An appellate court reviewing a grant of summary judgment must determine whether the trial court correctly found that there were no genuine issues of material fact. As findings of fact are not at issue, the trial court's decision is entitled to no deference.
B. Constitutionality of Kentucky’s Taxation System

“The test of the constitutionality of a statute is whether it is unreasonable or arbitrary.” A statute is constitutionally valid “if a reasonable, legitimate public purpose for it exists, whether or not we agree with its ‘wisdom or expediency.’” The Davises’ burden is heavy as “[a] strong presumption exists in favor of the constitutionality of a statute.”

Bearing those principles in mind, we now turn our attention to the Davises’ contention that Kentucky’s system of taxing only extraterritorial bonds violates the Commerce Clause of the United States Constitution. This issue is a matter of first impression in Kentucky.

The Commerce Clause simply provides that Congress has the power to “regulate Commerce with foreign Nations, and among the several States[.]” But despite the fact that the Commerce Clause “is phrased merely as a grant of authority to Congress to ‘regulate Commerce . . . among the several States,’ Art. I, § 8, cl. 3, it is well established that the Clause also embodies a negative command forbidding the States to discriminate against interstate trade.” This “negative” or dormant aspect of the Commerce clause “prohibits economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.” Thus, the “fundamental command” of the Commerce Clause is that “a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.” As a result. “[s]tate laws discriminating against interstate commerce on their face are ‘virtually per se invalid.’”

Clearly, Kentucky’s bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds. Thus, Kentucky’s bond taxation system may be found to be constitutionally valid only if it falls within an exception to the normal rule requiring laws that violate the Commerce Clause on their face to be stricken. So we must evaluate the Department’s three main arguments in support of Kentucky’s taxation system to determine if the Department has met its burden to show that the taxation system in question is constitutionally permissible.

First, one of the Department’s main arguments in favor of Kentucky’s taxation system is the fact that a similar system has been held to be constitutionally permissible in Ohio. In fact, despite the discriminatory bond taxing system’s widespread use and obvious Commerce Clause implications, apparently, only the Ohio courts have been presented with a case challenging it on Commerce Clause grounds. The Ohio Court of Appeals ultimately concluded in Shaper that the bond taxation system was constitutionally permissible. But that court failed fully to analyze the issue. Shaper, though containing a well-written preliminary analysis of the Commerce Clause implications of this discriminatory bond taxing system. “made no attempt to explain why . . . a tax exemption that discriminates against income earned from out-of-state bonds . . . is permissible under the Commerce Clause.” Rather, the Shaper court “tersely stat[ed], in effect, that ‘we looked and did not find anything so therefore it must be constitutional.’” Logic dictates, however, that a potentially problematic and constitutionally infirm statute does not become permissible simply
because it has not been previously found to be unconstitutional. Rather, a court faced with a direct constitutional challenge to a statute must engage in a searching inquiry to determine whether a challenged statute can pass constitutional muster. Thus, *Shaper*, though instructive in certain areas, is, in and of itself, insufficient to support the Department’s position, meaning that we must examine the Department’s other two main arguments.

The Department next argues that the bond taxation system must be found to be constitutional under the Supreme Court’s holding in *Bonaparte v. Tax Court*. In *Bonaparte*, a taxpayer contended that her state of residence was required by the Full Faith and Credit Clause of the United States Constitution to exempt out-of-state bonds from taxation because the issuing state exempted them. The Supreme Court rejected the taxpayer’s argument, holding that “no provision of the Constitution of the United States prohibit[ed] such taxation.” However, *Bonaparte* is ultimately of little value to the case at hand because the Commerce Clause played no role in the *Bonaparte* court’s decision. As the case at hand involves a direct challenge under the dormant Commerce Clause and has nothing to do with the Full Faith and Credit Clause, it logically follows that *Bonaparte* is neither on point nor controlling.

Finally, the Department relies upon the market participant doctrine to save Kentucky’s bond taxation system. The market participant theory “recognizes that when a sovereign acts as a consumer or vendor in commerce, its actions as a market participant are distinct from its actions as a market regulator. The Commerce Clause is directed at the state’s actions as a market regulator; therefore, [a State’s] actions as a market participant are exempted from Commerce Clause analysis.” Stated differently, the market participant theory “differentiates between a State’s acting in its distinctive governmental capacity, and a State’s acting in the more general capacity of a market participant; only the former is subject to the limitations of the negative Commerce Clause. Thus, for example, when a State chooses to manufacture and sell cement, its business methods, including those that favor its residents, are of no greater constitutional concern than those of a private business.”

The Department’s market participant argument is unavailing, however. No one could seriously argue against the principle that Kentucky acts as a market participant when it issues bonds. But Kentucky’s issuance of bonds is not the issue. Rather, the sole issue is Kentucky’s decision to tax only extraterritorial bonds. Thus, the market participant theory is inapplicable as a State’s “assessment and computation of taxes” is, clearly, “a primeval governmental activity.” Accordingly, “when a state chooses to tax its citizens, it is acting as a market regulator[.]” not as a market participant. Therefore, the Department’s market participant argument is without merit.

Having found that the Department’s arguments are unavailing, we are left with a situation in which Kentucky’s bond taxation scheme is facially unconstitutional under the Commerce Clause; and none of the arguments in favor of its constitutionality offered by the Department or relied upon by the trial court are sufficient to save it. But under the facts presented in this case, we have no choice but to find that Kentucky’s system of taxing only extraterritorial bonds runs afoul of the Commerce Clause. Thus, the trial court’s decision to grant summary
judgment to the Department was erroneous.

B. Standing

The trial court found that the Davises lacked standing to assert claims on behalf of all non-individual claimants (i.e., corporations, trusts, estates, etc.) because they had not shown that they had been forced to pay any taxes on extraterritorial bonds on behalf of those types of entities. On appeal, the Davises contend that the trial court confused the concept of standing with the somewhat related issues involved in class certification. We agree.

Class actions in Kentucky are governed by Rules of Civil Procedure (CR) 23.01-23.04. The Davises’ complaint sets forth their intention to prosecute their claims as a class action on behalf of all individuals, corporations, trusts, estates, etc. CR 23.03(1) provides that “[a]s soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained.” Thus, “[i]n a class action a plaintiff generally files a motion seeking certification of the class even though this is not expressly required by statute or rule.” In the case at hand, the Davises had not filed a motion for class certification before the Department filed its motion for summary judgment. So any issues regarding the propriety of class certification were not before the trial court. Rather, the only issues before the trial court were whether the bond taxation system in question was constitutional and whether the Davises had basic standing to file the action.

The question of standing only goes to whether an individual is entitled to have his or her claims resolved by a court. Thus, although standing is a threshold issue and a prerequisite for all actions, in order to demonstrate standing, a party need only show that a case or controversy exists between that party and the defendant. Only after a plaintiff has established personal standing in a putative class action may a court consider the separate issue of whether the plaintiff will be able to represent the proposed class adequately under the guidelines of CR 23.01—23.04.

In the case at hand, the trial court found that the Davises had personal standing to assert claims regarding the bond taxation issue. Thus, the Davises have standing. The question of whether the Davises may properly represent corporations, trusts, and estates comes into play only when the issue of class action certification is presented. Thus, the portion of the trial court’s opinion finding that the Davises lack standing is vacated. Upon remand, the Davises will, presumably, quickly move for class certification, at which time, the trial court may determine all of the issues involved in resolving such a matter, including whether the Davises can properly represent any corporations, trusts or estates.

IV. CONCLUSION

For the foregoing reasons, the Jefferson Circuit Court’s order granting summary judgment to the Department of Revenue is VACATED; and this case is REMANDED for further proceedings consistent with this opinion.

ALL CONCUR.
WASHINGTON, May 21—In a case with the potential to rattle, if not reshape, the market for state and municipal bonds, the Supreme Court agreed on Monday to decide whether states can continue to exempt interest on their own bonds from their residents' taxable income, while taxing the interest on bonds issued by other states.

The preferential tax treatment for in-state bonds is longstanding and very common, offered by nearly all the states that have an income tax. State and local governments issued more than $350 billion worth of bonds a year from 2002 to 2006.

The practice was, in fact, largely taken for granted until it was declared “facially unconstitutional” in January 2006 by the Kentucky Court of Appeals. That state court, ruling in a case brought by a Kentucky couple, George and Catherine Davis, who own bonds issued by other states, said the preferential tax treatment erected a barrier against interstate commerce in violation of the Constitution's commerce clause.

In the only previous decision on the subject, an Ohio state appeals court upheld that state’s preferential treatment of bond interest, in a 1994 decision that the Supreme Court declined to review. The fact that two state courts now disagree on such a fundamental question probably led the justices to conclude that the issue required their attention.

The National Association of State Treasurers, without taking a bottom-line position, urged the justices to accept Kentucky’s appeal.

“Only this court can resolve the uncertainty,” the state treasurers said, adding: “Regardless of the merits of the question presented, the federal Constitution should apply uniformly to all 50 states.”

The tax-exempt status of state and municipal bonds permits issuers to borrow money at a lower interest rate because investors are willing to accept lower returns in exchange for not having to pay taxes on the interest they receive. The tax-exempt feature is very appealing to investors, as reflected in the popularity of mutual funds that offer baskets of a single state's public debt. Kentucky filed its Supreme Court appeal, Department of Revenue of Kentucky v. Davis, No. 06-666, in November. Rather than act immediately, the justices held the case while they were considering how to decide another case about the permissibility of state preferences under the commerce clause.

On April 30, the court decided that case. United Haulers Association v. Oneida-Herkimer Solid Waste Management Authority, No. 05-1345. By 6 to 3, the court rejected a commerce clause challenge to a program in two upstate New York counties that required private haulers to deliver all solid waste to a single publicly owned landfill. It did not violate the commerce clause for the government to prefer itself over private-sector competitors. Chief Justice John G. Roberts Jr. wrote for the majority.

Ordinarily, once the court has decided a case, it sends back to the lower court any related case that it has been holding, so that the lower
court can reconsider its ruling in light of the new Supreme Court decision. But in this instance, the justices evidently concluded that the solid-waste decision did not shed much light on what the commerce clause might have to say about preferential taxation of bond interest.

In recent years, the court has been fairly aggressive about reining in state policies that could be described as protectionist. Two years ago, for example, the justices invoked the commerce clause to overturn laws in New York and Michigan that gave preferential treatment to in-state wineries.

But the court is hardly of one mind, either on basic principles or their application. Two justices, Clarence Thomas and Antonin Scalia, do not accept the premise that the commerce clause, which in the constitutional structure is a grant of authority to Congress, imposes any limitation on activity by the states. On the other hand, the newest justice, Samuel A. Alito Jr., dissented last month from the solid-waste decision, writing that “the public-private distinction drawn by the court is both illusory and without precedent.”

In the latest case, Kentucky is raising an argument based on state sovereignty, objecting that the state court’s analysis of the commerce clause “commandeers Kentucky’s tax laws to subsidize other states’ public debt if it wishes to exempt its own debt from taxation.”

In fact, the Kentucky Court of Appeals did not dictate a remedy for the constitutional violation it found. If the decision is upheld, the state will have the choice of exempting every state’s bond interest, or none.

The case will be argued in the fall, with a decision unlikely before next spring. That means that the municipal bond market could be unsettled for months, said Alan D. Viard, a resident scholar at the American Enterprise Institute and a former Federal Reserve Bank of Dallas economist. . . .
"Ky. Ruling Would Lift Tax on Out-of-State Bonds"

The Bond Buyer
January 10, 2006
Tedra DeSue

ATLANTA—The Kentucky Court of Appeals on Friday ruled it was unconstitutional for the state to tax interest received by its residents from municipal bonds issued outside its borders. [The case, Department of Revenue of Kentucky v. Davis, was later granted certiorari by the Supreme Court.]

While there is agreement that the state will likely appeal the decision to the state Supreme Court, observers say that if the case is not appealed and the ruling is left to stand, it could raise borrowing costs for issuers in Kentucky. It could also encourage similar challenges to taxation by other states of bonds sold by out-of-state issuers.

A spokesperson for the Department of Revenue said department officials had no comment on potential effects of the ruling or whether the decision would be appealed, because they had not had time to review it.

In the case, first brought in 2003 against the department by George W. Davis and Catherine V. Davis, the appeals court found that it was clear that Kentucky’s taxation system for bonds is unconstitutional because it “obviously” affords more favorable tax treatment to in-state bonds than it does to “extraterritorially issued bonds.”

In coming to its ruling, the appeals court acknowledged other cases in which similar systems of taxation were challenged, including a case in Ohio. There, the state Court of Appeals ruled the bond taxation system was constitutional, but the Kentucky Court of Appeals found that the court failed to fully analyze the issue.

The Kentucky ruling also provides that the plaintiffs would be within their rights to seek class action certification for their court challenge. That would mean the state could be on the hook for refunding taxes not only to the Davises but also others who joined the lawsuit, if it is ultimately successful.

Municipal bonds issued for “public purposes” are exempt from federal income tax. Most states with an income tax do not tax municipal bonds sold by issuers within the state, but do tax interest on bonds issued out of state but owned by state residents. State tax exemption for in-state bonds and taxation of out-of-state issues motivates investors, especially in high income tax states, to buy bonds sold by local issuers.

Kentucky’s income tax rate ranges from 2% to 6%.

State officials could not comment on how much money in lost revenue the state would experience if it could no longer tax the income from out-of-state municipal bonds and/or had to grant refunds. Ronald Dieckman, a senior vice president and director at underwriter and financial adviser J.J.B. Hilliard, W.L. Lyons Inc. in Louisville, said the ruling was the most significant development he’d seen in his 30 years in the business related to municipal bonds in
Kentucky. “It’s pretty earth shattering.”

He said the firm was taking a wait-and-see approach on the issue. “We have clients that have moved here from other states and who have bonds in those states, and they want to know what they should do,” he said. “We are waiting to see how the courts will finally resolve the issue.”

If the tax on out-of-state bonds is found ultimately to be unconstitutional, it would likely lead to the state’s bonds trading more cheaply. “They could trade cheaper to other bonds in the market because Kentucky would no longer be considered a specialty state,” Dieckman said. “It could also open the door for all states for similar types of challenges.”

Standard & Poor’s assigns an issuer credit rating of AA-minus with a stable outlook to Kentucky. Moody’s Investors Service assigns an issuer rating of Aa2 with a negative outlook. Fitch Ratings does not have an issuer rating for the state, but it rates Kentucky’s appropriation-backed debt AA-minus.
A Kentucky couple recently won a courtroom battle in a case that is stirring widespread interest among municipal-bond investors and state government officials. The couple challenged a state law taxing them on interest from most non-Kentucky municipal bonds while exempting interest on bonds issued within Kentucky. Most other states with a state income tax have a similar rule: They typically tax interest on most out-of-state municipal bonds but don’t tax interest on bonds issued within their own state.

Kentucky’s Supreme Court has declined to review an appeals-court ruling saying it’s unconstitutional for the state to tax only out-of-state bonds. John Wylie, a lawyer in Chicago for George W. Davis and Catherine V. Davis, says he is handling similar cases for taxpayers in Arizona and North Carolina.

The Davis case could embolden investors in other states to bring similar challenges, lawyers say. “This Kentucky case certainly has the potential for disrupting the landscape” of the $2.3 trillion municipal-bond market, says Len Weiser-Varon, a lawyer in Boston at the law firm Mintz, Levin, Cohn, Ferris, Glovsky and Popeo P.C.

John Farris, Kentucky’s Finance and Administration Cabinet secretary, added: “From Kentucky’s perspective, this issue isn’t so much about lost revenue, but rather market access for our schools, state and local governments and the potential for increased cost to our municipal issuers and those across the nation.”

Whether the U.S. Supreme Court will agree to review the case remains unknown. But Kentucky “should be able to make a compelling case for the U.S. Supreme Court to grant certiorari and rule on the constitutional question,” says Mr. Weiser-Varon of Mintz Levin.

For upper-income investors, municipal bonds long have been a very popular investment. Nearly 4.4 million federal income-tax returns reported tax-exempt interest income for 2004, according to the Internal Revenue Service. The total amount of tax-exempt interest income these investors reported came to nearly $50 billion.

Single-state municipal-bond funds have grown enormously popular. According to Morningstar Inc., there now are more than 530 single-state muni-bond funds available for investors.

Many investors prefer to buy municipal bonds issued within their home state—or shares of single-state municipal-bond funds. That’s
especially true of investors in high-tax areas, such as New York City, California and New Jersey. “Most municipal-bond investors don’t want to pay any taxes on any munis,” says Robert Lamb, a professor at New York University’s Stern School of Business. That’s one of the reasons the Davis case could be so significant, Prof. Lamb says.

For example, many New York City residents buy bonds issued within New York State in order to get “triple tax exemption.” That means they don’t owe federal, state or local tax on the interest from their bonds. If, however, a New Yorker buys Connecticut bonds, the interest would be tax free at the federal level but subject to New York State and New York City taxes.

In the [Department of Revenue v.] Davis case, Kentucky’s Court of Appeals decided earlier this year that Kentucky’s system of taxing only out-of-state bonds “runs afoul” of the U.S. Constitution’s Commerce Clause, which gives Congress the power to regulate commerce with other nations and among the states.

In a court document, Kentucky said the appeals court opinion, if it isn’t overturned, “will have an adverse impact” on the ability of the state and its political subdivisions to raise money by borrowing. The state said the advantage of an exemption from taxation for interest on in-state bonds is that “it provides an inducement” for Kentucky investors to buy Kentucky bonds while at the same time enabling the state and its political subdivisions “to pay less interest on those bonds.”

So far, “the bond market has shrugged it off as a nonevent, says Tom Metzold, a vice president and portfolio manager at Eaton Vance Management in Boston, which manages over $13 billion in municipal securities. He says the main reason for the lack of reaction earlier this year probably was a recognition among investors of “the significant amount of time that this would take to play out in the courts.”

Jill Midkiff, a spokesman for Kentucky’s revenue department, said yesterday it would be “difficult right now” to estimate how much it might cost Kentucky if the state eventually has to exempt interest on out-of-state bonds as well as in-state issues.

As for Mr. and Mrs. Davis, they “really prefer not to have any comment” on the case, a family spokeswoman says.

Reaction to the Davis case is beginning to heat up among tax-law professors. Several law professors have weighed in with different views on a popular blog, “TaxProf Blog.” ([http://taxprof.typepad.com](http://taxprof.typepad.com)), run by Paul Caron, a law professor at the University of Cincinnati College of Law. Richard Pomp, of the University of Connecticut School of Law, agrees with the ruling, saying Kentucky’s exemption of out-of-state bonds “discriminates against the interstate flow of capital.”
WASHINGTON—The National Association of State Treasurers filed an amicus brief with the U.S. Supreme Court last week that urges the court to review a high-profile Kentucky tax-exempt interest dispute that has captured the attention of the municipal market.

The brief urges the case’s immediate review by the court without taking a position on the case, which challenges the constitutionality of taxing interest earned on out-of-state issued bonds while exempting the interest earned on intrastate debt.

"In view of the vital importance of municipal bonds to state and local government, and the centrality of their tax-exempt status, this is an important question that should be decided promptly by this court," said the brief, written by Robert A. Long, a partner at Covington & Burling LLP here.

It comes three months after the state asked the court to consider the dispute, which was first tried in 2003 when married Kentucky residents George W. Davis and Catherine V. Davis argued that the state’s taxation policies violated the so-called “dormant” commerce clause of the Constitution by discriminating “on its face” against the holders of bonds issued by “sister states and/or their political subdivisions.”

Review by the court is important for the muni market because it could prevent Kentucky and 41 other states from taxing the interest on out-of-state bonds owned by state residents. The case is Department of Revenue of the Finance and Administration Cabinet, Commonwealth of Kentucky v. George W. Davis.

When first tried in 2003, a state circuit court ruled that the Davis’ lacked standing to challenge the tax code and upheld that taxing out-of-state bonds served a “reasonable, legitimate public purpose” because the state has an interest in attracting local funds for local public works projects.

But on appeal last January, the Kentucky Court of Appeals ruled in the Davis’ favor and rejected all three of the state’s arguments. The Kentucky Supreme Court declined to hear the case in August, paving the way for the request for review by the nation’s highest court.

Though much of the NAST brief reads like a tutorial on the muni bond market, the crux of its argument says that the Supreme Court will eventually have to step in to resolve the issue at stake—the legality of preferential tax treatment for in-state bonds—and that it ought to do so now rather than wait for additional challenges.

“‘The issue is squarely presented by this case, and the prior decisions of this court provide an adequate basis for deciding it,’” the brief said. “Moreover, municipal bond markets will function most efficiently if the legal uncertainty created by the Kentucky court’s decision is resolved promptly.”
In its petition filed in November, Kentucky argues that only the high court can resolve confusion between the appeals court ruling and a conflicting 1994 Ohio appellate court ruling. In that case, Shaper v. Tracy, which also involved bonds, the Ohio court recognized that the "commerce clause was simply never intended to apply to acts of a sovereign on behalf of itself where the end result is to provide the taxing state with a competitive advantage over another sovereign." The state also argues that the Kentucky appeals court ignored Supreme Court precedent going back to the 1880s that affirms the legality of taxing out-of-state bonds.

But in a separate petition that also was filed last week, attorneys for the Davis family urged the court not to hear the case, arguing among other things that the Shaper decision was decided prior to the court's further development of the dormant Commerce Clause law in a handful of subsequent cases. Included on that list of cases is a 2005 decision, Granholm v. Heald, in which the court struck down laws in New York and Michigan that permitted in-state wineries to ship wine directly to customers, but prohibited out-of-state wineries from doing the same.

"When a state statute directly regulates or discriminates against interstate commerce, or when the effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute without further inquiry," the Davis’ response brief said, citing Granholm.

The Davis’ brief is further dismissive of the Kentucky argument, noting that a court decision the state cites from 1881, Bonaparte v. Tax Court, is "equally unpersuasive" because it was not challenged on Commerce Clause grounds, nor did it revolve around the same type of "discriminatory" tax at issue in the Kentucky case.

That case dealt only with the question of whether one state could tax interest earned by its own residents on the debt of another state, the Davis’ brief said.

“The question here is not whether Kentucky can tax its residents income from other states’ municipal bonds, but rather whether it can do so while at the same time exempting from taxation income derived from its own bonds,” the brief said. “The Bonaparte court was not faced with the latter issue, and its holding is irrelevant to its resolution.” The court is expected to announce if it will hear the Kentucky case in the coming weeks.
I. Introduction

Do states violate the dormant commerce clause when they exempt from tax their own bonds but not bonds from other states? The Supreme Court will resolve that question next term in *Davis v. Kentucky*. The Court granted certiorari to review a decision of the Kentucky Court of Appeals, which held unconstitutional the portion of the Kentucky income tax code that grants an exclusion for in-state, but not out-of-state, municipal bond interest. The Kentucky decision conflicts with *Sharper v. Tracy*, a decision by the Ohio intermediate appeals court that discriminatory taxation of out-of-state municipal bonds was constitutionally permissible.

* * *

II. The Nondiscrimination Principle

A basic rule that springs from contemporary Supreme Court cases is that a state tax rule discriminating in favor of in-state activities is presumptively unconstitutional. A rule is discriminatory if a taxpayer’s effective tax rate increases when the taxpayer conducts economic activity out of state compared with what the effective tax rate would have been had the taxpayer engaged in the same activity in-state.

The Court has applied that rule with a fair degree of consistency; constitutionality has generally not turned on the specific tax mechanism that creates the bias against interstate commerce. Exclusions, credits, deductions, and special modifications to the
rate of tax have all been found unconstitutional. Indeed, since its landmark Complete Auto decision in 1977, the Court has never upheld a tax it deemed to be discriminatory.

***

III. Defenses for Discriminatory Regulation

Against that backdrop, the case favoring constitutionality for tax provisions favoring in-state municipal bonds appears thin. There are, however, at least two distinct arguments that states could advance: (1) the market participation exception to the dormant commerce clause, and (2) an argument that discrimination favoring state-run operations (particularly those that can be classified as “traditional”) is subject to far less-exacting constitutional scrutiny than discrimination favoring instate business.

The first argument is weak. Until the Supreme Court announced its decision in United Haulers, the second argument also seemed quite weak, based on the reasoning of the Court’s opinion in C&A Carbone, Inc. v. Town of Clarkstown. However, in the wake of United Haulers, initial reports suggest it now seems likely that Kentucky’s statute, and other state tax laws favoring in-state municipal bonds, will survive constitutional attack. We first explain why the market participation doctrine won’t shield state income tax preferences for in-state municipal bonds, and then assess the fledgling doctrine that regulation (possibly including tax laws) that favors state or local government is effectively exempted from the dormant commerce clause.

A. The Market Participation Doctrine

The Court has upheld blatant discrimination by states in favor of in-state businesses when the state buys printing services, sells cement, purchases abandoned vehicles, or hires workers. That rule, referred to as the market participation doctrine, is an exception to the normal rule of “virtual per se invalidity” for facially discriminatory regulation. The rationale underlying the rule is that states, just like private merchants, should be free to choose their trading partners.

Note, however, that this exception extends only as far as the concept of a market “participant” can take it. By its logic, the market participation exception should permit states to discriminate only to the extent that they are acting as an “ordinary” participant in the market would or could. . . . For instance, purchasers . . . don’t set prices. Therefore, a state’s decision to acquire, say, cement, would not also empower it to regulate cement prices in a way that contravened the dormant commerce clause. Thus, the inherent difficulty with that rule is determining when the state is acting as market participant and when it is acting as regulator.

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There are difficult cases in which classifying the government’s activity as market participation or regulation is ambiguous, but Davis isn’t one of them. Taxation is a “regulatory” function, not one performed by market participants. And although there might be economically equivalent transactions that would make the state a “direct” seller of higher-rate bonds to its taxpayers, the form states have chosen does not. Thus, the Court couldn’t plausibly conclude that exemption for municipal bond interest was market participation instead of regulation without overruling or at least severely limiting New Energy. . . .
B. The Nascent State-Run Businesses Exception

Until recently, then, the prospect that states could constitutionally exempt only their own bonds from taxation appeared quite dim. The scene may have brightened considerably with the Supreme Court's recent decision in United Haulers. United Haulers appears to announce a rule providing that state regulations in favor of a government-run enterprise will be subject only to mild scrutiny. That suggests, in turn, that a state tax regime favoring bonds issued by state and local government need clear only a relatively low constitutional hurdle. As we will explain, however, we believe that ultimately United Haulers is distinguishable from the municipal bond case and therefore that it too will not provide shelter for differential taxation of in-state and out-of-state municipal bonds.

1. United Haulers.

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United Haulers has fairly obvious implications for Davis and other cases presenting the same issue. Like the ordinance granting the townships a monopoly in United Haulers, state tax laws imposing tax only on out-of-state municipal bonds are "laws favoring local government." They therefore should have to meet only the relatively forgiving balancing test for "legitimate local concerns with effects upon interstate commerce that are only incidental." Importantly, however, Chief Justice Roberts was able to gather only three other votes for the proposition that revenue generation can be a proper purpose that might justify state regulation with incidental effects on commerce. . . . It is possible, therefore, that revenue raising will also be an invalid consideration in support of nondiscriminatory laws having an incidental effect on interstate commerce, such that states will have to point to some reason other than revenue for denying an exemption for out-of-state municipal bonds.

2. Distinguishing Davis from United Haulers.

Despite the similarities, we think that in the end, United Haulers is distinguishable from the case of differential taxation of in-state and out-of-state municipal bonds. Most significantly, while both Davis and United Haulers involve "discrimination" (in the nontechnical sense) in favor of a local government project, the municipal bond scenario discriminates against a different set of actors. While the ordinance at issue in United Haulers discriminated against all trash haulers, whether local or out of state, the state municipal bond provisions discriminate only against out-of-state issuers of municipal bonds, which are themselves public entities. . . . Perhaps more importantly, the absence of private in-state competitors issuing municipal bonds suggests that there are only minimal political checks on the state's decision to distort the interstate market for capital.

a. The Public-Private Distinction.

The outcome of United Haulers turns on the "public" character of the project favored by the monopoly right challenged there. . . . [T]he Court relied on the fact that the trash facility was government-owned to draw an inference that the ordinance was not "simple economic protectionism." Also, the fact that the facility was public played a role in the Court's formal doctrinal analysis. . . . It then asserted, in essence, that public entities are not substantially similar to private entities and therefore that the ordinance at issue in United Haulers did not "discriminate."
If we take that syllogism at face value, the taxation of municipal bonds would seem clearly distinguishable from *United Haulers*. State income tax provisions imposing tax on municipal bonds issued by government entities outside the taxing state benefit in-state municipal bond issuers at the cost, not of private entities, but rather of other governments. . . . The state is interfering, not in public vs. private competition, but in public vs. public. . . .

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There are at least two good reasons to distinguish private-public competition from public-public competition.

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First, we think state autonomy deserves little regard when the state exercises it to discriminate in favor of its own public entity at the expense of other, rival public entities. . . .

Second . . . the *United Haulers* Court presumed that laws favoring local government are likely to serve “legitimate goals,” rather than mere protectionism. In the case of laws affecting public-public competition, however, the inference that the law serves some public good, other than entrenching the enacting officials against outside competition, is rather weaker. Therefore, again, the values of free trade should assume a greater importance in the Court’s balancing. . . .

b. Where are the competitors?

Another important difference between *United Haulers* and in-state municipal bond preferences is the identity of the competitors affected by the preference. . . .

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. . . [W]e . . . think it is distinguishable from the municipal bond scenario. . . . [T]he disparate taxation of municipal bonds straightforwardly enriches the taxing state at the expense of sister states, which, by definition, cannot be directly represented in the political process. And, unlike the out-of-state trash haulers in *United Haulers*, who could rely on the efforts of local haulers, out-of-state municipal bond issuers have no concentrated, similarly burdened in-state constituency to make their case for them.

IV. Conclusion

*United Haulers* is an important decision, with many interesting implications for the law of the dormant commerce clause. On balance, however, we think *Davis* is distinguishable. The ordinance upheld in *United Haulers* was subject to powerful political checks from concentrated local constituencies with a strong motive to oppose the ordinance, checks simply not present when states discriminate against bonds issued by other states. And, while *United Haulers* lifts the presumption of unconstitutionality from laws favoring state-run businesses in competition with private business, it is doubtful that the Court would turn such a favorable eye on laws shielding state officials from the pressure of competition with rival state-run enterprises. Therefore, we predict that, if constitutional law remains as it stands, state laws exempting only in-state tax-exempt bonds will be found to violate the dormant commerce clause.
Plaintiff-appellant Charles Riegel underwent a percutaneous transluminal coronary angioplasty, during which his surgeon used an Evergreen Balloon Catheter. Dr. Roccario ultimately inserted the Catheter into Riegel’s artery and inflated the device several times, up to a pressure of ten atmospheres. The device label for the Evergreen Balloon Catheter specifies that it should not be inflated beyond the “rated burst pressure” of eight atmospheres. On the final inflation, the Evergreen Balloon Catheter burst, and Riegel began to rapidly deteriorate. He developed a complete heart block, lost consciousness, was intubated and placed on advanced life support, and was rushed to the operating room for emergency coronary bypass surgery. Riegel survived, but according to his Complaint, he suffered “severe and permanent personal injuries and disabilities.” Riegel subsequently filed suit against Medtronic, alleging five state common law causes of action: (1) negligence in the design, testing, inspection, manufacture, distribution, labeling, marketing, and sale of the Evergreen Balloon Catheter; (2) strict liability; (3) breach of express warranty; (4) breach of implied warranty; and (5) loss of consortium. In its amended answer, Medtronic raised the affirmative defense of federal preemption by Section 360k(a) of the 1976 Medical Device Amendments, 21 U.S.C. § 360c-k, to the Food, Drug, and Cosmetic Act, 21 U.S.C. §§ 301 et. seq, and subsequently moved for summary judgment on its preemption defense.

**Question Presented:** Whether the express preemption provision of the Medical Device amendments to the Food, Drug, and Cosmetic Act, 21 U.S.C. §360k(a), preempts state-law claims seeking damages for injuries caused by medical devices that received pre-market approval from the Food and Drug Administration.
forth in Section 360k(a) of the 1976 Medical Device Amendments to the Food, Drug, and Cosmetic Act, 21 U.S.C. §§ 301 et. seq. Specifically, we must decide whether Section 360k(a) preempts common law tort claims regarding medical devices that have entered the market pursuant to the Food and Drug Administration's ("FDA") rigorous premarket approval ("PMA") process. The Supreme Court left open this question in Medtronic v. Lohr, 518 U.S. 470, 116 S. Ct. 2240, 135 L. Ed. 2d 700 (1996), which held that tort claims as to medical devices that have entered the market pursuant to the far less intensive premarket notification process (often referred to as the "Section 510(k) process") are not preempted by Section 360k(a). Since Lohr, the majority of circuits addressing this question have held that claims regarding PMA-approved medical devices are, by contrast, preempted. . . .

We now join this growing consensus and hold that tort claims that allege liability as to a PMA-approved medical device, notwithstanding that device's adherence to the standards upon which it obtained premarket approval from the FDA, are preempted by Section 360k(a). We therefore affirm the district court's (Kahn, J.) summary judgment dismissal of the plaintiffs-appellants' strict liability, breach of implied warranty, and negligent design, testing, inspection, distribution, labeling, marketing, and sale claims as to the Evergreen Balloon Catheter, a PMA-approved medical device. With regard to the plaintiffs' remaining claim for negligent manufacturing—which premised liability on the theory that the particular Evergreen Balloon Catheter deployed during plaintiff-appellant Charles Riegel's angioplasty had not been manufactured in accordance with the PMA-approved standards—we agree with the district court that this claim was not preempted, but that no genuine issue of material fact existed, and thus affirm the district court's summary judgment dismissal of that claim as well.

We note that our preemption analysis is quite limited in scope, affecting the small universe of cases resting on claims alleging liability despite a PMA-approved device's adherence to the standards upon which it secured FDA premarket approval. We take care to explain that we do not hold that all state tort claims as to PMA-approved devices are preempted. Thus, tort claims that are based on a manufacturer's departure from the standards set forth in the device's approved PMA application—such as the Riegels' negligent manufacturing claim—are not preempted.

I.

A.

In a March 14, 2002 opinion, the district court (Kahn, J.) ruled that the Riegels' strict liability claim, breach of implied warranty claim, and all of their negligence claims except for the negligent manufacturing claim were preempted by Section 360k(a), and therefore dismissed all of these claims. The court let stand the Riegels' breach of express warranty claim. Thus, discovery continued on the two remaining substantive claims: the negligent manufacturing claim and the breach of express warranty claim. Medtronic later moved for summary judgment on these two remaining claims, and on December 2, 2003, the district court granted that motion. . . . The Riegels proceeded to file the instant appeal. . . .

II.

. . . With regard to the March 14, 2002 dismissal of many of the Riegels' claims on preemption grounds, there are no disputed facts, and "our task is to determine whether the district court correctly applied the law."
Pagan v. NYNEX Pension Plan, 52 F.3d 438, 441 (2d Cir. 1995) (internal quotation marks omitted). With regard to the December 2, 2003 dismissal of the Riegels’ negligent manufacturing claim, we must decide whether, “construing the evidence in the light most favorable to the non-moving party and drawing all reasonable inferences in its favor,” there are any genuine issues of material fact. SCS Communications, Inc. v. The Herrick Co., Inc., 360 F.3d 329, 338 (2d Cir. 2004).

III.

A.

We begin with the preemption issue, for which, at the outset, it is helpful to review the overarching regulatory structure. In 1976, Congress enacted the Medical Device Amendments (“MDA”) to the 1938 Food, Drug, and Cosmetic Act, in order to “provide for the safety and effectiveness of medical devices intended for human use.” 90 Stat. 539. The MDA established a regulatory structure pursuant to which the Department of Health and Human Services, through the FDA, would regulate medical devices.

Under the MDA, medical devices are categorized into three classes, based on the level of risk that they pose. 21 U.S.C. § 360c(a)(1). First, those devices that “present minimal potential for harm to the user,” such as elastic bandages, are classified as “Class I” devices; such devices can be marketed without prior approval and are subject only to “general controls” that cover all medical devices. 21 U.S.C. § 360c(a)(1)(A); see also http://fda.gov/cdrh/devadvice/3132.html (last visited April 28, 2006); Lohr, 518 U.S. at 477, 116 S.Ct. 2240. Second, devices that are potentially more harmful, such as powered wheelchairs and infusion pumps, are classified as “Class II devices.” These devices can still be marketed without advance approval, but in addition to being subject to “general controls,” they may also be subject to “special controls,” such as postmarket surveillance, patient registries, and/or other measures deemed necessary. 21 U.S.C. § 360c(a)(1)(B). Finally, those devices for which “general controls” and “special controls” are insufficient to provide reasonable assurance of safety and effectiveness, and which either “present a potential unreasonable risk of illness or injury” or are “for a use in supporting or sustaining human life or for a use which is of substantial importance in preventing impairment of human health” are classified as Class III devices. 21 U.S.C. § 360c(a)(1)(C).

It is undisputed that the Evergreen Balloon Catheter—the device at issue in this litigation—is a Class III device.

A Class III device is required to undergo “premarket approval to provide reasonable assurance of its safety and effectiveness” before being marketed. 21 U.S.C. § 360c(a)(1)(C). The premarket approval, or “PMA,” process is lengthy and rigorous. . . . The manufacturer must submit a detailed PMA application that contains full reports of all investigations of the safety and effectiveness of the device; a full statement of the components, ingredients, properties, and principles of operation of the device; a full description of the methods used in the manufacture and processing of the device; information about performance standards of the device; samples of the device; specimens of the proposed labeling for the device; and any other relevant information. 21 U.S.C. § 360e(c).

. . . Typically, the initial PMA application must include data from clinical investigations to establish the safety and effectiveness of the device, 21 C.F.R. § 814.20(b)(6)(ii); the manufacturer cannot even conduct such a
clinical investigation in the first place without FDA permission. . . . The FDA then reviews the submission to determine whether it is sufficiently complete to enable a substantive review; if not, the FDA will refuse to file it. 21 C.F.R. § 814.42. After having accepted the PMA for filing, the FDA begins its review, which may involve referring the PMA to an advisory committee. 21 C.F.R. § 814.44. . . .

Once the FDA has concluded its review, it decides whether or not to approve the device for marketing. This choice is not binary; the FDA has means to impose additional requirements. . . . The FDA thus has quite broad authority to approve, deny, and effectuate modifications of an application throughout the PMA process.

. . . Any changes that the applicant believes could affect the safety or effectiveness of the device must be submitted, via a “PMA supplement,” to the FDA for approval. 21 C.F.R. § 814.39(a). . . .

Additionally, the standard FDA “Conditions of Approval” accompanying a PMA order state that continued approval of the PMA “is contingent on the submission of post-approval reports required under 21 CFR 814.84 at intervals of 1 year from the date of approval of the original PMA.” . . . The standard PMA “Conditions of Approval” also require the manufacturer to submit an “Adverse Reaction Report” or “Device Defect Report” to the FDA within ten days after it receives or has knowledge of information concerning (1) “a mixup of the device or its labeling with another article”; (2) “any adverse reaction attributable to the device that has not been addressed by the device’s labeling or is occurring with unexpected severity or frequency”; or (3) “any significant chemical, or other change or deterioration in the device or any failure of the device to meet the specifications established in the PMA that could not cause or contribute to death or serious injury but are not correctable by adjustments or other maintenance procedures described in the approved labeling.”

The vast majority of Class III medical devices, however, reach the market without ever going through the rigorous PMA process described above. This is because the MDA also includes a “grandfathering” provision that “allows pre-1976 devices to remain on the market without FDA approval until such time as the FDA initiates and completes the requisite PMA.” Lohr, 518 U.S. at 478. And, in order to “prevent manufacturers of grandfathered devices from monopolizing the market while new devices clear the PMA hurdle, and to ensure that improvements to existing devices can be rapidly introduced into the market,” the MDA also allows new devices that are “substantially equivalent” to such pre-existing devices to enter the market without going through the PMA process. Id. This “substantial equivalence” route to the market is known as the premarket notification, or “§ 510(k),” process.

In its decision, the Lohr Court noted that the § 510(k) premarket notification process has become the means by which most new medical devices enter the market. Id. at 479. . . .

As the contrasting terms “premarket notification” and “premarket approval” suggest, the § 510(k) process differs dramatically from the PMA process. Unlike the PMA process—which requires reasonable assurance that the new device is itself safe and effective, and ultimately results in the FDA’s “approval” of the device—the § 510(k) process simply requires the manufacturer to show that the device is substantially equivalent to, i.e., as safe and effective as, a legally marketed device that did not go through the PMA process. . . . To
At that end, "[t]he § 510(k) notification process is by no means comparable to the PMA process; in contrast to the 1,200 hours necessary to complete a PMA review, the § 510(k) review is completed in an average of only 20 hours." *Id.* at 478-79. . . .

In fact, the FDA regulations explicitly prohibit manufacturers of devices that have reached the market through the § 510(k) process from indicating that the FDA has actually approved their device on the merits. . . .

Once a device has entered the market pursuant to the § 510(k) process, its manufacturer has broader latitude to make changes on its own than does the manufacturer of a PMA-approved device. . . .

Having summarized the PMA and § 510(k) routes to market set forth by the MDA, we now move to one final aspect of the MDA that is crucial for purposes of this case. The MDA also includes an express preemption provision: Section 360k(a). In relevant part, this provision states as follows:

> [N]o State or political subdivision of a State may establish or continue in effect with respect to a device intended for human use any requirement—

(1) which is different from, or in addition to, any requirement applicable under this Act to the device, and

(2) which relates to the safety or effectiveness of the device or to any other matter included in a requirement applicable to the device under this Act. 21 U.S.C. § 360k(a).

The application of Section 360k(a)'s preemption provision to medical devices that have entered the market through the two alternate routes described above—the PMA process and the § 510(k) process—forms the crux of this case.

B.

During the several decades following the 1976 enactment of the MDA, the circuit courts grappled with how broadly to construe Section 360k(a)'s preemption of state "requirement[s]" that differed from or added to "requirement[s] applicable under this Act." Could a state requirement be created by state common law, or only by state statutes and other enactments? For that matter, did approval under the PMA process—or, alternatively, clearance under the § (k) process or some other expedited process—amount to a requirement under the Food, Drug, and Cosmetic Act with which state law could conflict?

This Court addressed some of these questions in *Becker v. Optical Radiation Corp.*, 66 F.3d 18 (2d Cir. 1995). There, we stated that state common law claims that alleged product defects as to a PMA-approved device, notwithstanding that device's compliance with the PMA process, would be preempted by Section 360k(a). . . . The *Becker* Court was not, however, presented with the question of whether common law claims as to § 510(k)-cleared devices would be similarly preempted.

It was this latter question that the Supreme Court considered in *Lohr*, where the plaintiffs brought various state tort law claims in regard to the design, manufacturing, and labeling of a pacemaker that had entered the market pursuant to the § 510(k) process. In the course of assessing whether these plaintiffs' tort law
claims would—if successful—result in a state law “requirement” that differed from, or added to, a federal “requirement,” a fractured Court reached several conclusions.

All nine justices agreed that the § 510(k) process set forth no federal requirements as to the design of medical devices, and that clearance through the § 510(k) process simply reflected the FDA’s conclusion that a new device was substantially equivalent to a pre-existing device. Thus, the justices unanimously agreed that design defect claims as to § 510(k)-cleared devices would not be preempted by Section 360k(a) of the MDA because there would be no federal requirements with which such claims could conflict.

... When the justices moved from a consideration of the plaintiffs’ design defect claims to their manufacturing and labeling claims, however, they fractured over two issues regarding the interpretation of Section 360k(a)’s preemption of state “requirements” that were “different from, or in addition to, any requirement applicable under this Act.” First, the justices diverged over whether the reference to “requirements applicable under this Act” meant that only device-specific requirements could give rise to preemption, or instead meant that any FDA requirements could give rise to preemption. Five of the justices . . . concluded that only federal device-specific requirements could give rise to preemption. *Id.* at 497-500 (majority opinion). These justices therefore agreed that because the only FDA manufacturing and labeling requirements that covered the pacemaker at issue were general in nature rather than device-specific, the plaintiffs’ manufacturing and labeling claims were not preempted. By contrast, the remaining four justices . . . concluded that even general FDA requirements could give rise to preemption, and therefore dissented, in part, on grounds that the plaintiffs’ manufacturing and labeling tort claims as to the pacemaker were preempted by the general FDA manufacturing and labeling requirements.

In addition to their 5-4 split over whether the applicable federal requirement needed to be device-specific, the justices also divided—again by a 5-4 margin—over whether a state “requirement,” as that term was used in Section 360k(a), could derive from state common law or only from state statutes and regulations. Justices Stevens, Kennedy, Souter, and Ginsburg largely adopted the view that only the latter category would typically give rise to a state requirement for purposes of the MDA, stating in Part IV of the opinion that “when Congress enacted § 360k, it was primarily concerned with the problem of specific, conflicting state statutes and regulations rather than the general duties enforced by common-law actions,” *id.* at 489 (plurality opinion), and subsequently stating in part VI of the opinion that “it is apparent that few, if any, common-law duties have been preempted by this statute. It will be rare indeed for a court hearing a common-law cause of action to issue a decree that has ‘the effect of establishing a substantive requirement for a specific device,’” *id.* at 502-03 (plurality opinion).

... In sum, therefore, five justices endorsed the proposition that a state “requirement” for purposes of the MDA, could stem from state common-law actions as well as from state statutes or regulations.

We thus interpret *Lohr* as setting forth two main principles, each endorsed by five justices, for determining whether a common law tort action over a medical device is preempted by the MDA. First, on the federal side of the analysis, courts must consider whether there are any device-specific federal requirements with respect to the device at
hand. If so, courts must then turn to the state side to determine whether there would be a conflict between that device-specific federal requirement and “any of the liability-creating premises of the plaintiffs’ state-law tort suit.” *Lohr*, 518 U.S. at 508.

Since *Lohr*, the majority of circuits have applied the above-described framework to conclude that common law tort actions as to PMA-approved devices, in contrast to § 510-cleared devices, are preempted by the MDA. These circuits have all concluded that (1) approval through the PMA process, unlike the § 510(k) process, amounts to a federal device-specific requirement, and (2) common law tort actions that allege liability as to a PMA-approved device, notwithstanding that device’s compliance with the PMA-approved standards, would conflict with that federal device-specific requirement.

**C.**

We now turn to the instant appeal of the district court’s March 14, 2002 order dismissing many of the Riegels’ claims on preemption grounds. We note, initially, that our *Becker* decision clearly indicated that tort law claims as to a PMA-approved device would be preempted by Section 360k(a) of the MDA. *See Becker*, 66 F.3d at 20. Because the Supreme Court subsequently spoke to the issue of Section 360k(a)’s preemptive scope in *Lohr*, however, we must revisit the issue to determine whether *Becker* is still good law.

Thus, following the *Lohr* Court, our analysis proceeds in two parts. First, we must consider whether, when a device such as the Evergreen Balloon Catheter obtains approval pursuant to the PMA process, it is subject to a “requirement applicable under this Act.” *i.e.*, a federal device-specific requirement. Second, we must analyze the Riegels’ tort claims to determine whether there is a conflict between that device-specific requirement and “any of the liability-creating premises of the [Riegels’] state-law tort suit.”

1.

We agree with the majority of circuits that have held that the relatively small subset of PMA-approved devices—in contrast to the much larger population of § 510(k)-cleared devices—are subject to federal device-specific requirements. In holding that § 510(k) clearance did not give rise to a federal device-specific requirement, the *Lohr* Court explicitly distinguished between the § 510(k) process and the PMA process, stating that the two processes were “by no means comparable.” *Lohr*, 518 U.S. at 478-79. Indeed, the *Lohr* Court expressly emphasized that (1) the § 510(k) process was focused on equivalence rather than safety; (2) the FDA itself stated that § 510(k) clearance did not “denote official FDA approval”; (3) the § 510(k) exemption did not appear to have been “intended to do anything other than maintain the status quo with respect to the marketing of existing medical devices and their substantial equivalents”; and (4) § 510(k) clearance could not be viewed as “requir[ing] [the device] to take any particular form for any particular reason.” *Lohr*, 518 U.S. at 493-94.

The PMA process utterly diverges from the § 510(k) process in each of these respects. First, although clearance through the § 510(k) process simply means that a device is substantially equivalent to a pre-existing device—which may or may not be safe and effective—approval through the PMA process requires reasonable assurance of the device’s substantive safety and effectiveness. Second, whereas § 510(k) clearance does not indicate official FDA approval, the FDA has made clear that approval through the PMA process *does* denote such official approval. Indeed, the FDA explains on its website that “PMA is
the most stringent type of device marketing application required by FDA. PMA approval is based on a determination by FDA that the PMA contains sufficient valid scientific evidence to assure that the device is safe and effective for its intended use(s).” Third, although the § 510(k) process essentially froze the status quo with respect to pre-1976 devices and their substantial equivalents, the PMA process was created as an entirely new regime for devices that were not substantially equivalent to older devices. Finally, whereas § 510(k) clearance does not reflect the FDA’s determination that the device should “take any particular form for any particular reason,” Lohr, 518 U.S. at 493, the PMA process expressly provides the FDA with the power to require the device to take a particular form in order to be approved as safe and effective. As noted above, once the FDA has concluded its review, it can issue an “approvable letter” stating that the FDA believes it can approve the application if “specific conditions” are agreed to by the applicant. Alternatively, if the FDA “believes that the application may not be approved,” it can “send the applicant a not approvable letter . . . [that] will describe the deficiencies in the application . . . and, where practical, will identify measures required to place the PMA in approvable form.” 21 C.F.R. § 814.44(f).

Moreover, once a device has obtained PMA approval, the manufacturer cannot make any changes that might affect the safety and effectiveness of the device without further FDA approval. At that point, therefore, the device is clearly subject to the federal, device-specific requirement of adhering to the standards contained in its individual, federally approved PMA.

The Riegels have argued that manufacturers of § 510(k)-cleared devices are also precluded from making changes without FDA approval, and that this did not prevent the Lohr Court from finding that § 510(k) clearance imposed no device-specific requirements. But their premise is not entirely accurate. As noted above, manufacturers of § 510(k)-cleared devices have broader latitude to make changes without FDA approval than do manufacturers of PMA-approved devices, given that they must only obtain approval when making significant changes. . . .

For these reasons, we conclude that the Evergreen Balloon Catheter, a PMA-approved device, was subject to the federal device-specific requirement of complying with the particular standards set forth in its approved PMA application. It is true that, as the dissent states . . . here the FDA approved Medtronic’s PMA application for the Evergreen Balloon Catheter without invoking its power to require additional alterations. As such, the only documents in the record from the FDA to Medtronic are generic letters informing Medtronic that the Evergreen Balloon Catheter has obtained PMA approval and that Medtronic must comply with the generally applicable “Conditions of Approval” governing all PMA devices. We believe, however, that this is not relevant to the analysis. . . . Apparently, . . . the FDA concluded that the Evergreen Balloon Catheter was safe and effective as currently constituted. It would be illogical to hold that because the FDA, after rigorous review, deemed the PMA application for the Evergreen Balloon Catheter acceptable in its present form, the Evergreen Balloon Catheter is less subject to a device-specific regulation than are devices whose initial PMA applications are inadequate and which obtain PMA approval only after significant back-and-forth with the FDA. Once the PMA process is complete, all PMA-approved devices are subject to the same federal device-specific regulation: complying with the standards set forth in their individual approved PMA applications.
The Riegels have also argued that with regard to their failure-to-warn claim relating to the labeling of the Evergreen Balloon Catheter, there is no applicable federal device-specific requirement because (1) the only federal regulation governing the substance of the Evergreen Balloon Catheter's label was 21 C.F.R. § 801.109, the same general regulation that the Lohr Court found not to be sufficiently device-specific to warrant preemption of the labeling claims as to the § 510(k)-cleared pacemaker device at issue; and (2) under 21 C.F.R. §§ 814.39(d)(1)-(2), manufacturers of PMA-approved devices can make certain labeling changes without pre-approval from the FDA, such as labeling changes that add or strengthen a contraindication, add or strengthen an instruction, or delete misleading, false, or unsupported information. The flaw in this argument is that, unlike in Lohr, here the FDA explicitly approved the labeling of the Evergreen Balloon Catheter through the PMA process. Indeed, when Medtronic wanted to revise the Evergreen Balloon Catheter's label, it submitted PMA supplements that requested approval for those revisions, and the FDA granted that approval. Thus, we need not reach the question of whether, had Medtronic subsequently changed the catheter's label pursuant to the §§ 814.39(d) process that permits certain changes without FDA approval, failure-to-warn claims as to that label would be preempted, because here there is no evidence that Medtronic ever made changes to the catheter's label other than through the PMA process.

As a court, we are constrained to observe, however, that the FDA's level of success in carrying out these responsibilities, rather than bearing on the legal question of whether PMA approval reflects a federal device-specific requirement, is ultimately a policy matter for Congress and the Executive to address.

Having ruled that the Evergreen Balloon Catheter was subject to the federal device-specific requirement of complying with the standards in its approved PMA application, we now move to the question of whether the Riegels' claims would, if successful, result in state "requirements" that differed from or added to those standards. We conclude that they would.

The Supreme Court first addressed the issue of whether a preemption provision's reference to state "requirements" encompasses state common law tort suits, in addition to state statute or other positive enactments, in Cipollone v. Liggett Group, Inc., 505 U.S. 504, 112 S. Ct. 2608, 120 L. Ed. 2d 407 (1992). There, in the context of interpreting the preemption provision contained in the Public Health Cigarette Smoking Act of 1969, 15 U.S.C. § 1334(b), a majority of the Court answered that question in the affirmative. See id. at 521-22 ("The phrase 'no requirement or prohibition' sweeps broadly and suggests no distinction between positive enactments and common law; to the contrary, those words easily encompass obligations that take the form of common-law rules.")

Since Lohr, the Supreme Court has held firm to the view that state "requirements" can be created by state common law actions.

We thus conclude that the Riegels' claims for strict liability, breach of implied warranty, and negligent design, testing, inspection, distribution, labeling, marketing, and sale would, if successful, impose state requirements that differed from, or added to, the PMA-approved standards for the Evergreen Balloon Catheter. These claims do not rest on the premise that the particular
catheter used during Mr. Riegel's angioplasty deviated from the standards contained in the approved PMA application for the Evergreen Balloon Catheter. Rather, the liability-creating premise of all of these claims is that the Evergreen Balloon Catheter itself, in its present PMA-approved form, is in some way defective and therefore requires modification.

The Riegels assert that a verdict in their favor would simply stem from generally applicable state common law duties, such as the duty to use due care and the duty to inform users and purchasers of about relevant risks. Therefore, they argue, such a verdict could not possibly create a state “requirement” that adds to, or differs from, any federal device-specific requirements for the Evergreen Balloon Catheter. We disagree. The Supreme Court made clear in Cipollone, Lohr, and Bates that common law actions, which are premised on the alleged violation of a legal duty, do impose requirements. As Justice O'Connor put it in Lohr, “state common-law damages actions operate to require manufacturers to comply with common-law duties.” Lohr, 518 U.S. at 510. Indeed, a verdict in the Riegels’ favor on any of these claims would represent a finding that the Evergreen Balloon Catheter had not adhered to the various state common law duties implicated by those claims, e.g., that its design did not comport with the duty of due care, or that its labeling did not comport with the duty to warn. Such a verdict would clearly differ from the FDA’s PMA approval of the device (and its related packaging, labeling, distribution, and so on) as being reasonably safe and effective, and, moreover, from the FDA’s prohibition against making any modifications affecting the device’s safety and effectiveness without first obtaining FDA approval.

In fact, it is unclear what a manufacturer of a PMA-approved medical device would do when faced with such a jury verdict on a plaintiff’s common law claims, given that the manufacturer would nonetheless be unable to make any modifications affecting the device’s safety and effectiveness without obtaining further FDA approval. Moreover, it is certainly conceivable that different juries would reach conflicting verdicts about the same medical devices, thus rendering it almost impossible for a device to comply simultaneously with its federal PMA (which, after all, can only change after an extensive process) and with the various verdicts issued by different juries around the country. In this regard, a finding of preemption is consistent with another purpose evident in the MDA’s legislative history: its desire to ensure that “innovations in medical device technology are not stifled by unnecessary restrictions,” and its corresponding recognition that “if a substantial number of differing requirements applicable to a medical device are imposed by jurisdictions other than the Federal government, interstate commerce would be unduly burdened.” H.R. Rep. No. 94-853, at 12, 45.

As such, although we agree with the dissent’s recognition of a general presumption against preemption, and with the dissent’s comment that the legislative history of the MDA is silent as to the specific issue of preemption of state tort liability . . . we believe that the above-discussed Supreme Court precedent makes clear that Section 360k(a)’s reference to state “requirements” should be interpreted to encompass state common law actions . . . For these reasons, we adhere to the rationale initially set forth by this Court in Becker, and hold that the Riegels’ strict liability, breach of implied warranty, and negligent design, testing, inspection, distribution, labeling, marketing, and sale claims are preempted by Section 360k(a) of the MDA. We thus affirm the district court’s March 14, 2002 order granting summary judgment to Medtronic on
these claims on preemption grounds.

By the same token, we agree with the district court's conclusion that the Riegels' negligent manufacturing claim was not preempted, to the extent that it rested on the allegation that the particular Evergreen Balloon Catheter that was deployed during Mr. Riegel's angioplasty had not been manufactured in accordance with the PMA-approved standards. A jury verdict in the Riegels' favor on this claim would not have imposed state requirements that differed from, or added to, the PMA-approved standards for this device, but would instead have simply sought recovery for Medtronic's alleged deviation from those standards. . . .

***

. . . Finally, we note that our conclusion is further supported by the FDA's recent determination that preemption is warranted with respect to this universe of cases, as indicated by the content of the May 14, 2004 amicus curiae brief that the FDA submitted upon request to the Third Circuit in connection with the Horn case, which implicated the same issue that we address here.

IV.

We now turn to the December 2, 2003 order that granted summary judgment to Medtronic on the Riegels' non-preempted negligent manufacturing claim.

The legal framework governing this claim is undisputed. Because the Riegels do not have the actual Evergreen Balloon Catheter that was used during Mr. Riegel's angioplasty, they can prevail only by proving by circumstantial evidence that it must have been defective. As the New York Court of Appeals recently explained, "[i]n order to proceed in the absence of evidence identifying a specific flaw, a plaintiff must prove that the product did not perform as intended and exclude all other causes for the product's failure that are not attributable to defendants." Speller v. Sears, Roebuck and Co., 100 N.Y.2d 38, 41, 790 N.E.2d 252, 760 N.Y.S.2d 79 (N.Y. 2003).

Medtronic, with reference to expert opinions, has argued that the Evergreen Balloon Catheter used during Mr. Riegel's angioplasty burst not because it was negligently manufactured, but rather because (1) it was inflated to 10 atmospheres, even though the label stated that it should not be inflated more than 8 atmospheres; (2) it was inserted into an artery that was "diffusely diseased" and "heavily calcified," even though the label stated that it should not be used in such instances (because calcium spicules can puncture the catheter); and/or (3) Dr. Roccario used metal stents that could have punctured the catheter. . . .

. . . We agree with the district court that the Riegels did not come forward with competent evidence excluding Medtronic's proffered causes as the origin of the rupture. . . . Although it may well be that inflating the balloon catheter up to ten atmospheres was the best decision under the circumstances, this does not indicate that the inflation was not the cause of the catheter's rupture.

. . . . The only affirmative evidence that the Riegels have adduced in support of their claim that the catheter must have had a manufacturing defect is the report of their expert, engineer Ted Milo, who offered the view that based on the nature of Mr. Riegel's injury, the catheter must have burst not longitudinally, but radially. which—in his view—apparently signified a manufacturing defect. The district court found, however, that Milo's conclusion that the catheter had burst
radially was based on "sheer surmise and conjecture rather than on any scientific basis," and therefore found it to be insufficiently substantiated to be admissible as expert testimony. We agree, and thus conclude that the district court did not abuse its discretion in refusing to admit this evidence.

... We believe that the district court was well within its discretion in concluding that Milo's opinion was not an admissible expert opinion and therefore could not serve as a basis for demonstrating a manufacturing defect. An expert opinion requires some explanation as to how the expert came to his conclusion and what methodologies or evidence substantiate that conclusion. ... In this case, Milo essentially provided no explanation as to how he had reached his conclusion that the rupture must have been caused by a manufacturing defect, and himself seems to have backed away from this conclusion in his deposition. It was therefore appropriate for the district court to exclude his opinion.

As a result ... [we] affirm the court's December 2, 2003 dismissal of their negligent manufacturing claim.

V.

For the foregoing reasons, we hereby AFFIRM the district court's March 14, 2002 and December 2, 2003 orders that, collectively, granted summary judgment to Medtronic on all of the Riegels' claims.

POOLER, Circuit Judge, concurring in part and dissenting in part:

The majority today holds that when a device has gone through the PMA process, all state tort claims regarding the design or labeling of that device are preempted. While the majority opinion skillfully negotiates a complex and splintered area of the law, I believe it overlooks two critical aspects of the preemption analysis: the presumption against preemption and congressional intent. Because both these factors weigh against a finding of preemption, I would resolve the close question of whether the PMA process constitutes a device-specific federal requirement in the negative and find that the Riegel's tort claims are not preempted. Therefore, I respectfully dissent.

I.

... The legislative history of the MDA provides no indication that Congress considered the preemption of state tort liability or even that Congress had any concern about litigation hampering the development of useful medical devices. See Lohr, 518 U.S. at 490-91 (plurality opinion). Similarly, contemporaneous analyses of the MDA are silent on the possibility of preemption of state tort claims. Id. at 491 n. 13. If Congress actually intended to preempt all state tort claims for defective devices, it seems unlikely that such a dramatic change from existing law would go entirely unmentioned, particularly considering the well-known, ongoing litigation over such devices as the Dalkon Shield. Id. at 491. The only discussion of the preemption provision that I have found indicates that it was primarily focused on preventing state regulatory schemes, which some states had adopted in the absence of federal regulation on the topic. H.R. Rep. No. 94-853, at 45-46. State tort remedies are not mentioned.

... Furthermore, the idea that all state tort claims are unambiguously preempted is "particularly dubious" considering it appears that until relatively recently neither the industry nor the FDA thought such claims were preempted. See Bates, 125 S. Ct. at 1801. It was over fifteen years after the MDA was enacted before the industry began to
assert preemption based on FDA approval as a defense to state tort suits. See Goodlin v. Medtronic, Inc., 167 F.3d 1367, 1381 (11th Cir. 1999) (noting that Slater v. Optical Radiation Corp., 756 F. Supp. 370 (N.D. Ill. 1991), aff'd, 961 F.2d 1330 (7th Cir. 1992), was one of the earliest cases in which this argument was raised). As recently as 1997, the FDA took the position that common law duties would be preempted only when the FDA has expressly imposed through regulation or order a specific substantive requirement applicable to a particular medical device and the state common law would impose a different or additional requirement on the same device.

Traditionally, state tort claims for negligent design or labeling have provided compensation to consumers when the manufacturer knew or should have known that the design of its product posed an unreasonable risk of harm, and the manufacturer fails to improve the design or warn the consumer about the risk. In addition, strict product liability has generally placed the burden of compensating injured users on manufacturers because they are in a better position to insure against the risk and spread that cost among those who benefit from the product.

Despite the majority's emphasis on the large number of hours spent reviewing each PMA application, the agency's track record indicates these concerns are far from academic. A May 1993 Report from a subcommittee of the House Committee on Energy and Commerce contained several case studies in which the FDA had awarded PMA to unsafe devices, and attributed these failures to an unwillingness or inability on the part of the FDA to compel manufacturers to provide sufficient data and to critically evaluate the data provided.

If Congress's goal in passing the MDA was to protect consumers, as it seems clear it was, then it is unlikely that it intended to preempt all state tort claims for design or labeling defects whenever a device has gone through the PMA process. Thus, I believe we must recognize a particularly strong presumption against preemption in this case.

II.

With these principles in mind, I turn to whether the particular state tort claims in this case are expressly preempted by Section 360k(a). To make this determination, the Supreme Court has instructed that we conduct "a careful comparison between the allegedly pre-empting federal requirement and the allegedly pre-empted state requirement to determine whether they fall within the intended pre-emptive scope of the statute and regulations." Lohr, 518 U.S. at 500. Because the lack of any device-specific federal requirement makes it impossible to make such a "careful comparison" with the state tort claims in this case, I would find the Riegels' claims have not been preempted.

I agree with the majority that Lohr requires us first to determine whether the PMA process imposes a device-specific federal requirement on the Evergreen Balloon Catheter.

Despite the fact that the PMA process focuses on safety and effectiveness while the 510(k) process focuses only on substantial equivalence, whatever requirements, if any, the PMA process imposes on a device are no more specific than those imposed by the 510(k) process.

The FDA's approval constitutes no more than a finding that the manufacturer has met the FDA's minimum requirements to show a device's safety and effectiveness. It does not
represent a reasoned consideration and rejection by the agency of possible alternative, safer designs. If the facts showed that the FDA had actually rejected the design improvement advocated by the Riegels' through their tort claims, this might be a different case. However, here the FDA simply issued a generic approval letter. Indeed, if the FDA were to determine that a particular device should be subject to substantive requirements, then it has the power to promulgate performance standards to that effect. Such performance standards, unlike PMA, would obviously constitute specific federal requirements with preemptive effect.

. . . For the same reasons, the majority's attempt to distinguish the limitation on changes after Section 510(k) approval, which was found not to create a requirement in Lohr, is unpersuasive. The fact that, after PMA, FDA approval is required for any change affecting the safety or effectiveness of the device, rather than only for a significant change, does not make the federal requirement any more specific nor does it mean the manufacturer is required not to make changes to improve the safety of the device.

III.

Because I would find the PMA process does not impose any federal device-specific requirement, there is no need for me to reach the question of whether state tort claims would be preempted by such a requirement. The majority finds the Riegels' claims for negligent design, strict product liability, breach of implied warranty, and loss of consortium have been preempted because PMA requires Medtronic not to alter the design, manufacturing, or labeling of the Evergreen Balloon Catheter. Despite the purpose of the MDA to protect consumers, I agree with the majority that at least some state tort claims could be preempted because they can impose "requirements" that are different from or in addition to the federal requirements. Nevertheless, because there is no specific federal requirement to compare to these state claims, and nothing prevents Medtronic from improving the design, manufacturing, or labeling of the Balloon Catheter, I would not find these claims have been preempted.

IV.

For the foregoing reasons, I respectfully dissent from the majority's finding of preemption. I do agree, however, that summary judgment was properly granted as to the Riegels' negligent manufacturing claim and concur in that portion of the judgment.
WASHINGTON—Setting the stage for a confrontation between the states and manufacturers, the Supreme Court said on Monday that it would hear an appeal raising the issue of whether the makers of medical equipment approved by the federal government may be sued under state law by patients injured by those devices.

Although the appeal will most likely turn on the Supreme Court’s interpretation of the 1976 medical devices amendments to the Food, Drug and Cosmetic Act, the case is part of a broader debate in Washington over the extent to which the Bush administration and Congress may preclude the states from imposing consumer regulations that are more stringent than the federal government’s.

Federal agencies under the control of Bush administration appointees have sought to adopt regulations covering matters as diverse as auto safety and medicine labeling to preclude active state prosecutors and trial lawyers from bringing lawsuits that would impose higher safety standards.

An array of agencies, including the Food and Drug Administration, the National Highway Traffic Safety Administration and the Consumer Product Safety Commission, have proposed or adopted rules that would make it more difficult for consumers to bring lawsuits under state laws that are more favorable to victims than are federal regulations.

Critics of the Bush administration say that the approach strips consumers of valuable state protections. Supporters say the federal effort to pre-empt the states sets uniform national standards and discourages overzealous state prosecutors.

In the case before the Supreme Court, both the Bush administration and the defendant company, Medtronic, had urged the justices to reject the appeal of a patient who was injured when a balloon catheter it made ruptured during an angioplasty in 1996.

The patient, Charles R. Riegel, and his wife, Donna, sued Medtronic for a variety of state tort law violations, including negligent design and breach of warranty. The company maintained that Mr. Riegel’s surgeon should not have used the balloon catheter because of Mr. Riegel’s condition and that the surgeon used the device in a manner inconsistent with its labeling.

Both a Federal District Court and a Federal Appeals Court in New York dismissed most of the Riegels’ claims. Those courts concluded that because the F.D.A. had approved the balloon catheter after a rigorous review and before it went to market, injured patients could not file claims against Medtronic under state law. The medical devices amendment forbids a state from adopting any requirement “which is different from or in addition to any requirement” in federal law.

Federal courts around the nation have taken different views of whether that provision bars state law damage claims against
medical devices approved by the F.D.A. The issue has so confounded the courts that three appeals courts reviewing the same medical device made by the same company have reached two different conclusions about whether patients could bring a lawsuit.

Lawyers involved in the Medtronic case say they expect the court to hear from manufacturers and business groups in support of Medtronic, as well as from states and consumer organizations on behalf of the patient who was injured. The case, *Riegel v. Medtronic*, No. 06-179, is expected to be heard by the court in the fall.

A group of similar cases involving drugs is moving through the courts.
The time and expense required to get an FDA premarket approval (PMA) for a device may be worth it, as some devicemakers are finding themselves in court after taking the more streamlined 510(k) approval route, compliance lawyers say.

The Supreme Court in recent cases has ruled that the standards required for 510(k) approval aren’t high enough to protect some device manufacturers from lawsuits in state courts.

"The suggestion inferred from the Supreme Court is that the 510(k) process does not bear out the safety of a device, whereas the PMA process does," said John Powers, a partner in Hancock & Estabrook. "You may get 510(k) approval, but you don't get the preemption from state tort law that you would get from the PMA process."

The reason: PMA requires a higher burden of proof of safety and effectiveness, while section 510(k) clearance requires only that a device be “substantially equivalent” to one already on the market.

As a result, liability lawsuits in state courts aren’t preempted by federal law and regulations in 510(k) cases, say product litigation experts. Under the law of preemption, federal regulations shield manufacturers from lawsuits in state court because the federal government has already enacted laws to regulate an industry.

“When deciding whether or not to do a 510(k) application, device manufacturers should carefully look forward to the likeliness of the potential for product liability claims, and factor this into their cost/benefit analyses,” Powers said.

To get their products to market faster, most manufacturers in the current $220-billion-a-year device market opt for 510(k) clearance, Powers said. In the seven years following the passage of the Medical Device Amendment Act of 1976 allowing for premarket clearance, 90 percent of all new Class III medical devices—ones that present a potential unreasonable risk of illness or injury—were approved via this route, he said.

**PMA Process Longer**

“In terms of PMA versus 510(k), PMA-approved devices have a preemption defense in state courts,” said Michael Brown, partner in law firm Reed Smith. “But approval is a longer process, more costly and takes a fair amount of time.”

On average, Brown said, a device manufacturer invests 1,200 hours in review, clinical trials and providing documentation in the PMA process, whereas 510(k) premarket approval may take as little as 20 hours of review. “With 510(k), somebody else has done all that legwork,” Brown said.

Brown should know. He represented Medtronic in *Riegel v. Medtronic*, a recent case that courts are looking to as a precedent. A federal appeals court rejected a product liability action against the device manufacturer. The court held, as six other
appeals courts have, that FDA approval of a “breakthrough” device preempts private plaintiffs’ suits, meaning federal regulations preclude state laws in such cases (Riegel v. Medtronic, 451 F. 3d 104, 2d Cir. 2006) [The Supreme Court will be hearing Riegel v. Medtronic, Inc. this fall].

In the Medtronic case, the U.S. Court of Appeals for the Second Circuit joined a “strong and convincing majority” of federal appellate courts in upholding device preemption for PMA devices, Brown said.

Tort Claims Preempted

The Riegel majority held “that tort claims that allege liability as to a PMA-approved medical device, notwithstanding that device’s adherence to the standards upon which it obtained premarket approval from the FDA, are preempted.” The majority explained that the PMA process involves “interaction between the FDA and the manufacturer,” and approval means “the applicant is required to comply with the standards in the PMA approval order,” Brown said.

The majority also concluded that state law tort claims could be preempted where “the liability creating premise” is “that the [device] itself, in its present PMA-approved form, is in some way defective and therefore requires modification.”

One judge did dissent, however. That judge’s analysis began by presuming that Congress would not have intended preemption of what it viewed as a basic state health and safety issue.

“The dissent also viewed Congress’ intent to preempt state law tort claims to be unclear, and found it improbable that Congress meant to protect consumers by placing their fate in the hands of the FDA, which it viewed as less than competent,” Brown said.
"Court Clarifies Right of Pre-Eemption in Medical Device Case"

New York Law Journal
June 28, 2006
Martin Flumenbaum and Brad S. Karp

In this month’s column, we report on a recent decision by the U.S. Court of Appeals for the Second Circuit, clarifying the scope of the preemption provision in §360k(a) of the 1976 Medical Device Amendments (MDA).

In Riegel v. Medtronic Inc., the panel majority (Judges Robert A. Katzmann and Barrington D. Parker) ruled that §360k(a) preempts common-law tort claims regarding medical devices that have entered the market pursuant to the Food and Drug Administration’s (FDA) premarket approval (PMA) process. Judge Rosemary S. Pooler dissented, reflecting the circuit split regarding the FDA’s premarket medical device regulatory approval process.

Legal Framework

Medtronic Inc. (Medtronic) produces the Evergreen Balloon Catheter (the catheter), a medical device used during an angioplasty, a heart procedure that opens clogged blood vessels. During an angioplasty, the catheter is inserted into the clogged vessel and the catheter is inflated like a balloon to open the artery. Afterwards, the catheter is deflated and removed. The FDA had approved Medtronic’s PMA application for the catheter.

The MDA were added to the 1938 Food, Drug and Cosmetic Act “to provide for the safety and effectiveness of medical devices.” They established a regulatory structure pursuant to which the FDA would regulate medical devices. Under the MDA, medical devices are divided into three classes, based on the level of risk to the user posed by the device. The FDA requires that only Class III devices, because they may present “a potential unreasonable risk of illness or injury,” must satisfy the PMA process in order to “provide reasonable assurance” of the devices’ “safety and effectiveness.”

PMA is the most onerous type of device marketing application required by the FDA. For example, the FDA spends approximately 1,200 hours reviewing a PMA application. The applicant, usually a device manufacturer, must receive FDA approval of its PMA application prior to marketing the device. The requirements to maintain PMA continue after the FDA approves the device. For example, post-approval reports must be submitted annually. Additionally, any changes that the PMA applicant believes could affect the safety or effectiveness of the device must be submitted to the FDA for approval.

Due to the onerous requirements of the PMA process, the vast majority of Class III medical devices reach the market without going through the PMA process. Through a “grandfathering” provision included in the MDA, most medical devices instead go through the “substantial equivalence” route to market. This is known as the “§510(k)” process, the section of the Food, Drug and Cosmetic Act from which it derived—or “premarket notification.” The §510(k) process allows devices to stay on the market as long as the manufacturer of the device can demonstrate that the device is substantially equivalent to: (1) a medical device legally in commercial distribution in the United States before May 28, 1976, or (2) a device that has
been determined by FDA to be substantially equivalent.

The §510(k) notification process is not comparable to the PMA process. For example, a §510(k) review is completed in an average of only 20 hours. Moreover, a manufacturer of a product subject to §510(k) review has broader latitude to make changes on its own than does the manufacturer of a PMA-approved device. In contrast to PMA-approved devices, the FDA prohibits manufacturers of devices that have reached the market through the §510(k) process from indicating that the FDA has actually approved their device on the merits.

The MDA’s pre-emption provision states:

[N]o State or political subdivision of a State may establish...with respect to a device intended for human use any requirement—

(1) which is different from, or in addition to, any requirement applicable under this chapter to the device, and

(2) which relates to the safety or effectiveness of the device or to any other matter included in a requirement applicable to the device under this chapter.

Since 1976, several courts have addressed the scope of the MDA’s pre-emption provision. In Becker v. Optical Radiation Corp., the Second Circuit determined that the MDA preempted state common-law claims. The court held that plaintiff could not pursue state tort claims because this would result in New York common law impermissibly adding requirements in areas reviewed in the premarket approval process and thus would impose standards on the medical device that were different from those set forth in the MDA.

Furthermore, in Medtronic, Inc. v. Lohr, the U.S. Supreme Court clarified whether pre-emption existed under §510(k). The Court unanimously agreed that design defect claims as to §510(k)-cleared devices would not be preempted by the MDA because the §510(k) process simply meant that a new device was substantially similar to a pre-existing device and thus did not set forth any federal requirements. Furthermore, a majority of the Court decided that only device-specific FDA requirements would give rise to preemption. Therefore, general MDA requirements, such as non-device-specific federal labeling and manufacturing requirements, would not preempt state requirements. Additionally, five Justices ruled that a “state requirement,” for purposes of the MDA, could arise from state common-law actions as well as from state statutes or regulations. The Supreme Court, though, did not specifically consider whether the PMA process imposed federal-specific requirements sufficient to preempt state law requirements.

Since Lohr, the majority of circuits have concluded that: (1) approval through the PMA process amounts to a federal device-specific requirement, and (2) common-law tort actions that allege liability as to a PMA-approved device, notwithstanding that device’s compliance with PMA-approved standards, would conflict with that federal device-specific requirement. Only the U.S. Court of Appeals for the Eleventh Circuit has held that the PMA process does not constitute a federal device-specific requirement.

Second Circuit Decision

The Second Circuit began its legal analysis by determining whether its Becker decision remained good law following Lohr. First, the
court analyzed whether a device, such as the catheter, was subject to a federal device-specific requirement. Second, the court analyzed whether a conflict existed between the device-specific requirement and any of the liability-creating premises of the Riegels' state-law tort suit.

The Second Circuit panel majority agreed with the majority of circuit courts that PMA-approved devices, in contrast to §510(k) cleared devices, are subject to federal device-specific requirements. Thus, the court found that catheter, a PMA-approved device, was subject to the federal device-specific requirement of complying with the particular standards set forth in its approved PMA application.

The panel majority disagreed with the Riegels' argument that the labeling of the catheter was not a device-specific requirement. First, the FDA had expressly approved the labeling of the catheter through the PMA process. Second, Medtronic had submitted PMA supplements to revise the catheter's label. Thus, preemption naturally occurred because no evidence existed that Medtronic made changes to the catheter's label other than through the PMA process.

After determining that the catheter was subject to the federal device-specific requirement of complying with the standards in its approved PMA application, the panel majority determined that, if successful, the Riegels' claims would result in state "requirements" that differed from or added to federal standards. Furthermore, the panel majority found that "state requirements" comprehend state common-law tort suits. Thus, the court held that the PMA approval process preempts state common-law tort actions, and affirmed the district court's grant of summary judgment to Medtronic on the preemption issue.

Finally, the court evaluated the Riegels' non-preempted negligent manufacturing claim and affirmed the district court's grant of summary judgment. In so ruling, the court pointed to the facts that Mr. Riegel's doctor had over-inflated the balloon past the maximum-rated burst pressure specified on the device label, that Mr. Riegel's blood vessels were of such a condition that the label on the catheter indicated a contraindication for such blood vessels, and that the expert engineer supporting the Riegels' claims based his position on "sheer surmise and conjecture rather than on any scientific basis".

Conclusion

Riegel has significance for both the medical device manufacturer as well as parties involved in medical device litigation in this circuit. First, manufacturers will have to weigh the difficulty of getting a device approved through the PMA process, rather than through the §510(k) process, against the value of the MDA preemption right over state tort claims. Second, defendants of a PMA-approved device can secure preemption of state tort law claims at summary judgment; to avoid dismissal at summary judgment, plaintiffs in the future will need to assert other causes of action, besides state tort common law claims, when bringing suit against the manufacturer of a PMA-approved device.
Stoneridge v. Scientific-Atlanta

(06-43)


In August 2000, Charter Communications, Inc. faced a year-end shortfall of their operating cash flow of between $15 million and $20 million. John Pietri, Charter’s Senior Vice President of Engineering was asked by Charter’s CEO and COO to approach Scientific-Atlanta and Motorola to purchase advertising, but both declined. Pietri was then instructed to propose sham transactions, the sole purpose of which was to generate the appearance of operating cash flow for the fourth quarter. Charter set up to purchase set-top boxes from the defendants and agreed to pay an additional $20 per set-top box, and in exchange, the defendants would use that $20 for advertising time. The defendants agreed to the sham transactions despite knowledge that Charter charged the defendants four or five times the market rate for the advertising time. The swap increased Charter’s operating cash flow by $17 million in the fourth quarter of 2000 to meet market expectations. The investors allege there was a violation of Rule 10b-5.

Questions Presented: Whether the Supreme Court’s decision in Central Bank of Denver v. First Interstate Bank of Denver forecloses claims for deceptive conduct under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5(a) and (c), 17 C.F.R. 240.10b-5(a) and (c), for transactions with a public corporation whose sole purpose was not legitimate business other than inflate artificially the corporation’s financial statements, but where the respondents made no public statements about the transactions.

In re: Charter Communications, Inc., Securities Litigation:
Stoneridge Investment Partners, Plaintiff-Appellant
v.
Scientific-Atlanta, Inc.; Motorola, Inc., Defendants-Appellees

United States Court of Appeals for the Eighth Circuit

Decided April 11, 2006

LOKEN, Chief Judge:

This is a securities fraud class action by Stoneridge Investment Partners on behalf of those who purchased Charter Communications, Inc., stock between November 8, 1999 and August 16, 2002. Plaintiffs alleged that Charter—one of the nation’s largest cable television providers—engaged in a “pervasive and continuous fraudulent scheme intended to artificially boost the Company’s reported financial
results” by deliberately delaying the disconnecting of customers no longer paying their bills, improperly capitalizing labor costs, and entering into sham transactions with two equipment vendors that improperly inflated Charter’s reported operating revenues and cash flow. Named as defendants were Charter; ten Charter executives during all or part of the class period; Arthur Andersen, LLP, Charter’s independent auditor during the class period; and the two equipment vendors, Scientific-Atlanta, Inc., and Motorola, Inc. (collectively, “the Vendors”).

Relying on Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), the district court granted the Vendors’ motion to dismiss plaintiffs’ claims under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the SEC’s implementing regulation, Rule 10b-5, 17 C.F.R. § 240.10b-5. The court then denied plaintiffs’ motions to reconsider the dismissal and to grant leave to file an amended complaint. Stoneridge appeals. We have jurisdiction because the district court entered a separate final judgment under Rule 54(b) of the Federal Rules of Civil Procedure. We affirm.

I.

1. The Standard of Review

Plaintiffs’ sixty-eight-page complaint is factually detailed, as it must be to satisfy the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b). Our de novo review accepts the facts as alleged in the complaint and draws all reasonable inferences in favor of Stoneridge in deciding whether the complaint satisfied these pleading requirements. See In re Navarre Corp. Sec. Litig., 299 F.3d 735, 740-48 (8th Cir. 2002).

2. The Scheme Alleged

At the time in question, Charter delivered cable services through set-top boxes installed on customers’ TV sets. Charter purchased the set-top boxes from third-parties, including the Vendors. In August 2000, although Charter had firm contracts with the Vendors to purchase set-top boxes at a set price sufficient for its present needs, Charter agreed to pay the Vendors an additional $20 per set-top box in exchange for the Vendors returning the additional payments to Charter in the form of advertising fees.

Plaintiffs alleged that these were sham or wash transactions with no economic substance, contrived to inflate Charter’s operating cash flow by some $17,000,000 in the fourth quarter of 2000 in order to meet the revenue and operating cash flow expectations of Wall Street analysts. Charter accomplished the deception with fraudulent accounting by improperly capitalizing the increased equipment expenses while treating the returned advertising fees as immediate revenue. Plaintiffs alleged that the Vendors entered into these sham transactions knowing that Charter intended to account for them improperly and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations. Plaintiffs did not allege that the Vendors played any role in preparing or disseminating the fraudulent financial statements and press releases through which Charter published its deception to analysts and investors.

3. The Governing Law

Section 10(b) makes it unlawful, directly or
indirectly, “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe.” 15 U.S.C. § 78j(b). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly . . .

(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

In Central Bank, the Supreme Court confirmed that § 10(b) prohibits only “manipulative or deceptive” devices or contrivances, and that private plaintiffs “may not bring a [Rule] 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b).” 511 U.S. at 173, 114 S.Ct. 1439. In earlier cases, the Court held that “deceptive” conduct involves either a misstatement or a failure to disclose. See Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474-75 & n. 15, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977); Affiliated Ute Citizens of the State of Utah v. United States, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972); accord United States v. O'Hagan, 521 U.S. 642, 653-655, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997). “Manipulative,” as used in the

securities context, is a “term of art” and refers to illegal trading practices such as “wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” Santa Fe, 430 U.S. at 476-77, 97 S.Ct. 1292, citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 & n. 21, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), and Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 43, 97 S.Ct. 926, 51 L.Ed.2d 124 (1977).

Based upon these earlier cases and the text and legislative history of the 1934 Act, the Court in Central Bank rejected the contrary position of the SEC and held that Rule 10b-5 does not reach those who only aid or abet a violation of § 10(b):

As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act . . . The proscription does not include giving aid to a person who commits a manipulative or deceptive act.

511 U.S. at 177, 114 S.Ct. 1439.

However, the concluding section of the Central Bank majority opinion added an important caveat:

The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material
misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.

Id. at 191, 114 S.Ct. 1439 (emphasis in original). This is one of many cases that have tested the boundaries of that caveat.

4. The District Court’s Decision

In a thorough Memorandum and Order, the district court concluded that Central Bank, as uniformly applied by a number of our sister circuits, precludes plaintiffs’ claims against the Vendors as nothing more than claims they aided and abetted Charter in committing § 10(b) violations:

The Court concludes plaintiffs’ claims against [the Vendors] are claims for aiding and abetting. Plaintiffs do not assert that [the Vendors] made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by either of them. Plaintiffs also do not allege that [the Vendors] were responsible for, or were involved with the preparation of Charter’s allegedly false or misleading financial statements; Charter’s allegedly improper internal accounting practices; or the allegedly false or misleading public statements made by Charter and its former executives. Plaintiffs also do not allege that any of the allegedly misleading statements listed in the amended complaint were made, seen, or reviewed by [the Vendors]. Instead, plaintiffs contend that [the Vendors] are liable to Charter’s investors on the basis that they engaged in a business transaction that Charter purportedly improperly accounted for.

Nor can [the Vendors] be held liable for any purported omissions as plaintiffs have not alleged that [the Vendors] had any duty to Charter’s investors. . . . The Court can find no precedent for the conclusion that business partners, such as [the Vendors], made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue.

Plaintiffs then filed motions for reconsideration and for leave to amend their complaint, citing additional cases and pleading additional facts. The district court denied both motions, concluding that the additional citations were unpersuasive and the proposed amendment would be futile because it merely reiterated the prior allegations with additional particularity.

II.

On appeal, Stoneridge argues that plaintiffs properly alleged a primary violation of the securities laws within the meaning of Central Bank because the Vendors violated Rule 10b-5(a) and (c) by participating in a “scheme or artifice to defraud” and by engaging in a “course of business which operates . . . as a fraud or deceit.” The argument emphasizes that Rule 10b-5(a) and (c) are broadly worded and, unlike Rule 10b-5(b), do not require proof of a fraudulent misrepresentation or failure to disclose. The argument depends on the
assertion that Central Bank's analysis did not affect the scope of primary liability under subparts (a) and (c), relying primarily on a recent district court decision, In re Parmalat Sec. Litig., 376 F.Supp.2d 472, 492-503 (S.D.N.Y.2005).

Like the district court, we reject Stoneridge’s narrow interpretation of Central Bank. We conclude that Central Bank and the earlier cases on which it relied stand for three governing principles: (1) The Court’s categorical declaration that a private plaintiff “may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b),” 511 U.S. at 173, 114 S.Ct. 1439, included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b). (2) A device or contrivance is not “deceptive,” within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose. See Santa Fe, 430 U.S. at 474-75, 97 S.Ct. 1292. (3) The term “manipulative” in § 10(b) has the limited contextual meaning ascribed in Santa Fe, id. at 476-77, 97 S.Ct. 1292. Thus, any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5. Accord Fidel v. Farley, 392 F.3d 220, 235 (6th Cir. 2004); Ziamba v. Cascade Int'l, Inc., 256 F.3d 1194, 1204-06 (11th Cir. 2001); Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998), cert. denied, 525 U.S. 1104, 119 S.Ct. 870, 142 L.Ed.2d 772 (1999); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1225-27 (10th Cir. 1996); In re Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 628 n. 3 (9th Cir. 1994); In re Dynegy, Inc. Sec. Litig., 339 F.Supp.2d 804, 914-16 (S.D.Tex. 2004); In re Homestore.com, Inc. Sec. Litig., 252 F.Supp.2d 1018, 1040-41 (C.D.Cal.2003).

In this case, the focus of plaintiffs’ § 10(b) and Rule 10b-5 claims was deception—they alleged a “continuous course of conduct” in which Charter allegedly “made and/or failed to correct public representations which were or had become materially false and misleading regarding Charter’s financial results and operations.” Indeed, eighteen pages of the amended complaint alleged in fifty detailed paragraphs the fraudulent financial reports and press releases published by Charter during the class period. However, neither Motorola nor Scientific-Atlanta was alleged to have engaged in any such deceptive act. They did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter’s true financial condition. None of the alleged financial misrepresentations by Charter was made by or even with the approval of the Vendors. Accordingly, the district court properly dismissed the claims against the Vendors as nothing more than claims, barred by Central Bank, that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs.

Like the district court and the court in In re Homestore.com, 252 F.Supp.2d at 1041, we are aware of no case imposing § 10(b) or Rule 10b-5 liability on a business that entered into an arm’s length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts. The point is significant. To impose liability for securities fraud on one party to an arm’s length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to
mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress.

III.

Finally, Stoneridge argues that the district court abused its discretion in denying plaintiffs’ post-dismissal motions to reconsider the dismissal order and to grant plaintiffs leave to amend the complaint. A district court has broad discretion to reconsider an order granting dismissal or summary judgment, but “[a] motion to alter or amend judgment cannot be used to raise arguments which could have been raised prior to the issuance of judgment.” Hagerman v. Yukon Energy Corp. 839 F.2d 407, 414 (8th Cir. 1988), cert. denied, 488 U.S. 820, 109 S.Ct. 63, 102 L.Ed.2d 40 (1988). Here, plaintiffs argued that the district court overlooked or misapplied prior decisions from district courts in other circuits. The district court briefly reviewed those cases and concluded it “is not inclined to reach a different result.” Denial of the motion to reconsider on this ground was not an abuse of discretion. Indeed, we agree with the court’s analysis of those non-controlling cases.

The district court denied the post-dismissal motion to amend because the proposed pleading would be futile—the additional allegations as to the Vendors’ role and knowledge set forth in the proposed amended complaint did not cure the flaws in plaintiffs’ § 10(b) theory. Denial of a motion to amend on this ground, particularly a motion filed after the district court’s final ruling, is not an abuse of discretion. See, e.g., Grandson v. Univ. of Minn., 272 F.3d 568, 575 (8th Cir. 2001), cert. denied, 535 U.S. 1054, 122 S.Ct. 1910, 152 L.Ed.2d 820 (2002).

The final judgment of the district court dated February 15, 2005, is AFFIRMED.
WASHINGTON (AP)—The Supreme Court said Monday it will consider whether shareholders of companies that commit securities fraud should be able to sue investment banks, lawyers and others that allegedly participated in the fraud.

Wall Street and law firms around the country are closely watching the case, which won’t be argued until the court’s next term beginning in October. Federal appeals courts so far have split on whether such “secondary actors” can be held liable.

“This is probably the most important legal issue for the securities industry in a generation,” said Robert Giuffra, an attorney at Sullivan & Cromwell who has defended corporations in securities cases.

Last week, the 5th U.S. Circuit Court of Appeals ruled against a class-action lawsuit brought by former Enron shareholders against several investment banks, including Merrill Lynch & Co. Inc. and Credit Suisse Group, over their alleged role in Enron’s collapse. The Houston-based oil services firm went bankrupt in 2001 after a widespread accounting scandal was uncovered. Several executives pleaded guilty or were convicted of fraud, and investors and former employees lost millions in the debacle.

The 5th Circuit found that the banks may have knowingly “aided and abetted” Enron’s fraud, but under a 1994 Supreme Court ruling, companies are generally protected from shareholder lawsuits even if they aid and abet fraud. However, the Securities and Exchange Commission can pursue civil actions in such cases.

The case the justices agreed to hear stems from an episode of alleged securities fraud by cable television provider Charter Communications Inc. in 2000. A Charter investor, StoneRidge Investment Partners LLC, sued Motorola Inc. and Scientific-Atlanta Inc., which is now owned by Cisco Systems Inc. StoneRidge alleged that the companies participated in sham transactions with Charter.

Legal experts refer to the notion of expanding liability to investment banks, lawyers and other involved parties as “scheme liability.”

James C. Dugan, an attorney at Willkie, Farr & Gallagher, said the StoneRidge case was one of the first opportunities for the justices to consider a scheme liability case. Their action “suggests that they think this is a very important issue that needs to be clarified,” he said.

Critics argue that it is an effort by plaintiffs’ lawyers to seek “deep pockets” to sue by evading legal standards on aiding and abetting, especially in cases such as Enron, which became worthless in the aftermath of its bankruptcy.

Barbara Roper, director of investor protection at the Consumer Federation of America, disagreed. “One way or the other, people who help commit the fraud ought to
be held liable,” she said.

In the Charter case, StoneRidge accused Motorola and Scientific-Atlanta of participating in a “scheme to defraud” investors.

In a court filing, StoneRidge alleged that Charter overpaid Motorola and Scientific-Atlanta for set-top boxes that Charter customers used to receive cable programming. Motorola and Scientific-Atlanta then in effect returned the overpayment by purchasing advertising from Charter, StoneRidge charged. The transactions allowed Charter to inflate revenue by $17 million, the amount needed to meet certain Wall Street analysts’ expectations, StoneRidge said.

Charter eventually restated financial statements from 2000 to 2002, reducing revenue during that period by $292 million. Four executives also pleaded guilty to felony counts of conspiracy to defraud.

A federal district court and the 8th Circuit Court of Appeals dismissed StoneRidge’s claims, however, finding that the two companies may have aided and abetted the fraud but were not active participants.

A company or individual must make a fraudulent statement or omit information, or engage in manipulative securities trading practices to be held liable for securities fraud, the 8th Circuit said.

The 9th Circuit Court of Appeals, however, ruled in a separate case later that a secondary actor, such as a bank or law firm, can be held liable in some circumstances—specifically, if its conduct had “the principal purpose and effect of creating a false appearance of fact.”

That ruling set up a federal appeals court conflict, which can sometimes spur the Supreme Court to weigh in.

WASHINGTON (Dow Jones)—The U.S. Justice Department on Monday let pass a deadline for supporting investors in a case before the Supreme Court, exposing disagreement within the government over how the court should rule in a case that may have implications for investors in Enron Corp. (ENE).

U.S. Solicitor General Paul Clement refrained from filing an amicus brief by a midnight deadline even though he had been asked to do so by the Securities and Exchange Commission. The SEC had voted 3-2 to recommend that the solicitor general advocate on behalf of investors in a case about whether third parties can be sued under federal securities laws for allegedly playing a role in another company’s accounting fraud.

A Justice Department spokesman would not say whether or when a brief would be filed.

The case has become a flashpoint in a larger debate over the Bush administration and its policies towards businesses. SEC Chairman Christopher Cox, a Republican who while in Congress sponsored legislation that restricted the ability of investors to sue for securities fraud, was subject to intense lobbying by plaintiffs’ attorney William Lerach. Cox ultimately broke ranks with fellow Republicans and voted to weigh in on behalf of investors.

Business groups, such as the U.S. Chamber of Commerce, have warned that allowing investors to sue third parties will make foreign companies think twice before doing business in the U.S.

The case involves a lawsuit against suppliers to Charter Communications Inc. (CHTR) over transactions in which the cable company allegedly inflated its revenue. The scheme involved paying Scientific Atlanta Inc., now a unit of Cisco Systems Inc. (CSCO), and Motorola Inc. (MOT) extra money for cable boxes if the companies purchased advertising from the cable company, allegedly generating $17 million in improper revenue.

A U.S. trial judge dismissed the lawsuit against the suppliers in a ruling that said Supreme Court precedent limited such suits to primary violators of federal securities laws. An appeals court later affirmed the trial court’s ruling.

The Supreme Court precedent at issue came in 1994, when the court ruled that third parties that do business with public companies can’t be sued by shareholders for “aiding and abetting” a fraud. The question is whether those outside parties may be sued as a “primary violator.”

The court’s ruling may have implications for private lawsuits against investment banks, law firms, and other outside parties doing business with a company that engages in fraud. One such case involves a federal appeals court ruling against Enron investors that said securities laws limit the ability to sue banks and investment firms that were doing business with the company.
Enron shareholders earlier this year asked the Supreme Court to review the decision. The court hasn’t said whether it will take up the case. Enron filed for bankruptcy protection in 2001 after a massive accounting scandal.

Lerach’s law firm lashed out at the government’s decision to let the deadline pass without submitting a brief.

"Vetoing the reasoned opinion of the lead regulatory agency represents an unprecedented imposition of politics into the judiciary—extraordinary even for this over-politicized Justice department,” said Dan Newman, a spokesman for the law firm Lerach Coughlin Stoia Geller Rudman & Robbins LLP.

The case is Stoneridge Investment Partners v. Scientific-Atlanta and Motorola, 06-43.
The Supreme Court's recent decision to review *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* may finally clarify an important question in private securities fraud actions: the circumstances under which market participants who are not themselves selling securities or making statements to investors, such as attorneys, accountants, investment banks, or others involved in the capital markets, may be held liable for violating the federal securities laws. In 1994, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Court held that secondary actors cannot be held liable in private securities actions for aiding and abetting another's fraudulent conduct. While limiting the scope of liability under § 10(b) of the securities Exchange Act of 1934 and Rule 10b-5 in the case before it, the Court observed toward the end of that opinion:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability. . . . Any person or entity . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability . . . are met.”

The Court left a more precise definition of “primary violator” or “primary liability” open to be addressed at a later time. It seems that time has arrived. Grappling to define that “open” question has divided lower courts ever since. The notion of “scheme liability,” a legal theory by which plaintiffs have sought with some success to limit the scope of the *Central Bank* decision, has crystallized a conflict on this issue which the Court now seems likely to resolve. Such a theory holds that secondary actors commit a primary violation where they and (usually) the company whose securities were affected by the alleged fraud, were part of a “scheme” to defraud investors. This theory has been employed to assert claims against numerous participants in the capital markets, including attorneys, accountants, banks, business partners, and even vendors who worked with a company affected by an alleged scheme.

Two conflicting approaches to the notion of “scheme liability” have developed. One, adopted by virtually all of the lower courts who have considered the question and most recently by the Eighth Circuit, is a bright line rule about what is required for a primary violation. The other approach, adopted by the Ninth Circuit, conflicts with that approach and results in a much less definite rule.

**Bright Line Approach to Primary Liability**

In *Stoneridge*, the Eighth Circuit followed what is clearly a majority view in adopting a bright line definition of “primary violation” by affirming the lower court’s decision in *In
re: Charter Communications, Inc. Securities Litigation. In Charter, investors in a company asserted § 10(b) and Rule 10b-5 claims, using a scheme liability theory, against a vendor of the company in which they invested. Specifically, they alleged that the vendor entered into sham transactions with the company—the company overpaid for equipment and the vendor returned the surplus payments as “advertising fees”—and that the vendor knew the company was using these transactions to improperly inflate its revenue on its financial statements. In dismissing the claims against the vendor, the court concluded that secondary actors are only liable as primary violators if they “make or affirmatively cause to be made a fraudulent misstatement or omission” or “directly engage in manipulative securities trading practices.” Since the vendor did not play any role in preparing or disseminating the fraudulent financial statements, the court held that it could not be held liable.

**Flexible Approach to Primary Liability**

Alone among those circuit courts who have considered this question, in Simpson v. AOL Time Warner Inc., the Ninth Circuit applied a flexible rule as to what constitutes a primary violation. In Simpson, investors asserted scheme liability claims against business partners of a company whose securities were affected by the alleged scheme. Like the Charter plaintiffs, the investors claimed that the partners engaged in sham transactions with the company knowing that the company was using those transactions to fraudulently inflate its revenue on its financial statements. Although the court dismissed the investors’ claims, it adopted a different definition of primary violation. It held that secondary actors are primary violators if their “conduct or role in an illegitimate transaction has the principal purpose and effect of creating a false appearance of fact in furtherance of a scheme to defraud.”

It seems clear that the time for the Supreme Court to address the question it left open in Central Bank has arrived. Hopefully, the decision in this case will resolve the conflict in the lower courts. Everyone who plays a role in the capital markets will benefit from a bright line definition of what constitutes a primary violation of the securities laws.
It is, by general consent, the most important securities-litigation clash for a generation. A case now before the Supreme Court, *Stoneridge v. Scientific-Atlanta*, is shaping up to be a key test of attitudes towards shareholder class actions. A decision in favour of aggrieved investors would greatly increase the number of companies on which trial lawyers could train their sights. A ruling the other way would be a crushing defeat for the plaintiff’s bar. Adding to the suspense, the government bodies with an interest in the case cannot agree on a common position.

The case involves a cable company, Charter Communications, which used a transaction with two suppliers of set-top boxes to inflate its revenues. Shareholders sued not only the company but the vendors too, claiming that they participated in the fraud, even though they may not have been aware of the misreporting. Led by the legendary Bill Lerach, plaintiff lawyers have lobbied ferociously for the principle of going after third parties, known as “scheme liability”.

The Securities and Exchange Commission (SEC) is backing Mr. Lerach’s lot, thanks to a change of heart by its Republican chairman. Christopher Cox, traditionally no friend of the plaintiff’s bar. Mr. Cox urged the Department of Justice to fall in behind it, but this week it declined to do so. It has a month to decide whether to support the defendants or offer no opinion.

The Treasury is at odds with the SEC, too, fearing that a ruling in favour of investors would further damage American competitiveness. Many foreign firms that choose to list their shares elsewhere point to America’s “litigation lottery” as the principal reason. Although filings of securities class actions have been falling since 2005, the overall value of settlements has continued to rise.

Bankers and accountants are watching just as closely as cable-box makers. In a similar case, Mr. Lerach’s firm sued Enron’s financial advisers on behalf of shareholders, claiming that they facilitated the bookkeeping shenanigans at the now-defunct energy trader. He lost—though not before collecting billions from banks that settled early. He has lodged an appeal with the Supreme Court and wants the case joined with *Stoneridge*.

What will the court do? Business is encouraged by its track record: a steady pruning of plaintiffs’ rights since the 1970s. (Congress, too, has made it harder to bring class actions.) A number of its justices are thought to sympathise with the view that scheme liability is best left to the SEC, which has the power to pursue aiders and abettors under its Rule 10b-5.

Some lawyers in Washington even suggest that Mr. Cox only sided with investors because he was convinced that they had almost no chance of support from the Supreme Court. “He’s been accused of being too close to business and this is a convenient way to dispel that notion without really changing anything,” says one.

But with numerous fine legal points at issue, the outcome is uncertain. An unfavourable ruling would send a chill through
boardrooms, and not only in America.

If suppliers and advisers can be dragged into class actions, it would no longer even be necessary to issue shares in the United States to incur securities liability, points out Peter Wallison of the American Enterprise Institute, a think-tank. Any firm, anywhere, doing business with American companies would have to live with the risk that the transaction could later be portrayed as fraudulent or deceptive. And painting such pictures is what trial lawyers do best.
Securities litigators at Atlanta's Alston & Bird office recently persuaded a federal appeals court to rule in favor of their client, Scientific-Atlanta, on what they call a hot topic in securities litigation.

On April 11, a panel of the 8th Circuit U.S. Court of Appeals said that shareholders of cable company Charter Communications cannot recover from Scientific-Atlanta and Motorola based on allegations that the technology manufacturers sold Charter cable boxes through "sham" transactions that Charter used to mislead its investors.

The 8th Circuit decision appears to be the first to rule on the argument raised by the plaintiffs, although corporate defenders contend that plaintiffs' attorneys simply are trying to put a new gloss on an argument rejected by the U.S. Supreme Court over a decade ago.

Plaintiff shareholders of the cable company filed suit in federal court in St. Louis in August 2002. They named Charter and ten of its executives, its auditor Arthur Andersen, Scientific-Atlanta and Motorola as defendants.

On behalf of investors who purchased Charter stock between Nov. 8, 1999 and Aug. 16, 2002, Stoneridge Investment Partners alleged that Charter had defrauded investors by artificially inflating the company's financial results by, among other things, deliberately delaying the disconnection of customers no longer paying their bills.

Charter experienced a precipitous decline in its stock price beginning in September 2001, when the price was around $20 a share. Now with a stock price of only a dollar and change and a market capitalization of around $469 million, the company lags behind the industry leaders.

Among the tactics that plaintiffs said Charter employed involved Charter's purchase of cable boxes from Scientific-Atlanta and Motorola. The plaintiffs alleged that in August 2000, Charter agreed to pay the cable box vendors an additional $20 a box over a previously set price in exchange for the vendors returning the additional payments to Charter in the form of advertising fees.

Charter used these transactions to inflate its cash flow by about $17 million to meet the fourth quarter 2000 expectations of Wall Street analysts, contend the plaintiffs. According to the plaintiffs' allegations, Charter improperly treated the increased equipment "expenses" as capital while treating the returned ad fees as revenue.

The plaintiffs did not allege that Scientific-Atlanta or Motorola played any role in disseminating false information to analysts or investors. However, the plaintiffs contended that these third party vendors were liable to them under securities laws because they knew Charter would account for the transactions improperly and deceptively.

No Liability

Last year, U.S. District Judge Charles A. Shaw said that allegation, even if proven, could not support liability under the securities
laws. The plaintiffs appealed, and Alston attorney Oscar N. Persons argued Scientific-Atlanta’s defense before the appeals panel.


In the 5-4 decision, the high court found that an indenture trustee for a bond issue could not be subject to “aiding and abetting” liability even though it let pass suggestions that a real estate developer was issuing false reports on the bond issue. Writing for the majority, Justice Anthony M. Kennedy said that the Securities Exchange Act of 1934’s proscription on material false statements or omissions did not create liability for “giving aid to a person who commits a manipulative or deceptive act.”

Charter shareholders argued before the 8th Circuit that Central Bank did not foreclose their suit against Scientific-Atlanta and Motorola because they had alleged not just that the vendors had aided Charter in committing a fraudulent misrepresentation or failure to disclose as forbidden by the securities laws but that the vendors themselves had violated broader proscriptions on participating in a “scheme or artifice to defraud” and engaging in a “course of business which operates as a fraud or deceit.”

The 8th Circuit panel rejected that argument, saying that under Central Bank and other cases “any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under 10(b) or any subpart of Rule 10b-5.”

May Go to High Court

Counsel for both Scientific-Atlanta and the plaintiffs shareholders say that the Supreme Court ultimately may take up the issue, depending on how other circuits rule. An appeal in an unrelated case on the issue is pending in the 9th Circuit, and district courts have ruled different ways.

For now, however, Persons, who represented Scientific-Atlanta with Susan E. Hund, also an Alston partner, will take the win for his client. “It’s been a hot topic, and we’re glad to see some closure come to it.”

Persons said that his client “did not know that any of our transactions were going to be used in an improper way” but that even if it had, it should not be subject to liability. “It’s not right to make a vendor responsible for accounting over which the vendor has no control,” said Persons.

Plaintiffs’ counsel Mark I. Gross of Pomerantz Haudek Block Grossman & Gross in New York said that his clients were “actively considering seeking further review” of the 8th Circuit panel’s decision, most likely through a petition for consideration by the Supreme Court.

“From our standpoint we believe that in instances where there is a significant showing that a third party vendor was aware that it was directly contributing to a fraud upon investors that it should be held accountable for the impact of such misconduct.” said Gross in an interview.

Meanwhile, at about the same time that the plaintiffs filed their 8th Circuit appeal of the dismissal of the claims against the vendors,
the plaintiffs settled with Charter and Arthur Andersen. The settlement provides for the payment of $64 million in cash by Charter, $2.25 million in cash by Arthur Andersen, $40 million in Charter common stock and $40 million of Charter warrants, according to Shaw's June 2005 order approving the settlement.

Institutional Shareholder Services currently ranks the settlement the 26th largest final settlement of a private securities class action filed since 1996.

The case is *Stoneridge Investment Partners v. Scientific-Atlanta*, No. 05-1974 (8th Cir. April 11, 2006).
"Is ‘Deceptive’ Conduct Only Misstatements or Omissions?"

The New York Law Journal
May 8, 2007
Jeff G. Hammel and Robert J. Malionek

In Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 US 164, 180 (1994), the U.S. Supreme Court held that §10(b) of the Securities Exchange Act of 1934 “prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. . . .”

The proscription does not include “giving aid to a person who commits a manipulative or deceptive act.” As the Court further held, secondary actors in the securities markets still may face liability under §10(b), and Rule 10b-5 issued thereunder, for making a material misstatement or omission or employing a manipulative device “on which a purchaser or seller of securities relies.”

In recent years, plaintiffs in securities fraud litigation have attempted to extend the reach of primary liability beyond those who actually make statements or remain silent in the face of a duty to speak (the scenario covered by Rule 10b-5(b)) by alleging that the defendant committed “deceptive conduct” under Rule 10b-5(a) and (c) merely by participating in an alleged scheme to defraud.

Whether Central Bank forecloses such claims—a question that has received uneven treatment by lower courts—will be resolved by the Supreme Court next term. See In re Charter Communications, 443 F3d 987 (8th Cir. 2006), cert. granted sub nom. Stoneridge Investment v. Scientific-Atlanta, Inc., 75 USLW 3511 (U.S. March 26, 2007) (No. 06-43). The Stoneridge case should be watched closely, as the decision will have the potential to reshape securities fraud litigation for years to come.

Liability/Aiding, Abetting

Section 10(b) makes it unlawful, directly or indirectly, “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe.” 15 USC §78j(b). SEC Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security. 17 CFR §240.10b-5.

In Central Bank, the Supreme Court clarified that any private claim brought pursuant to Rule 10b-5 must satisfy Section 10(b)’s requirement that it be either “manipulative” (i.e., related to illegal trading practices, which is a “term of art” defined by earlier Supreme Court precedent) or “deceptive” (i.e.,
involving a misstatement or omission by one who has a duty to disclose). This ruled out liability for mere assistance in such conduct as a basis for liability. Because the plaintiffs in Central Bank alleged only an “aiding and abetting” claim, the Court had no occasion in that case to consider the requirements for stating claims under Rule 10b-5(b), regarding misstatements and omissions, as opposed to claims under Rule 10b-5(a) and (c), for other fraudulent acts and devices.

Nonetheless, the Court offered some guidance regarding the extent to which §10(b) reaches actors other than an alleged primary violator:

The absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.

This guidance in Central Bank has caused a split of authority among lower courts.

Misstatements and Omissions

Some courts have struggled with whether an actor’s “substantial participation” in an alleged misstatement (or omission) made by another actor is sufficient to state a claim under §10(b) and Rule 10b-5(b). Whereas other courts have held that an actor may face liability only for actually making the alleged misstatement (or remaining silent when obligated to speak). Nowhere has this split been more evident than within the U.S. Court of Appeals for the Second Circuit. Shortly after Central Bank was decided, the Second Circuit held that a secondary actor’s mere assistance in another’s alleged fraudulent statement—such as an accountant’s review of its client’s financial statements, without issuing an audit opinion or other public statement—is insufficient to impose liability in a private action under §10(b). See Shapiro v. Cantor, 123 F.3d 717, 721 (2d Cir. 1997); see also Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998).

Some district courts within the Second Circuit, however, subsequently held that plaintiffs may state a claim against a secondary actor where the level of participation by that actor in an alleged fraudulent misstatement (or omission) was significant enough to itself be considered fraudulent. See, e.g., In re Global Crossing Ltd. Sec. Litig., 322 F.Supp.2d 319, 333 (SDNY 2004) (defendant may be liable for another’s misstatement if defendant’s role is “substantial enough that s/he may be deemed to have made the statement”); In re Van Der Moolen Holding N.V. Sec. Litig., 405 F.Supp.2d 388, 402 (SDNY 2005) (subsidiary may be primarily liable for statements made by its parent where statements clearly identify the subsidiary as the source of the information disclosed).

Earlier this year, the Second Circuit rejected such a basis for primary liability by adopting a bright-line rule that an actor may bear responsibility for a statement only when the statement is publicly attributed to the actor. In Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147, 156 (2d Cir. 2007), Chief Judge Dennis Jacobs (and a panel including Retired Justice Sandra Day O’Connor) squarely held that an auditor may not be liable under §10(b) for helping to compile and reviewing—but not auditing—its client’s interim financial
statements included in Form 10-Q, when the issuer attributed no statement made in the Form 10-Q to the auditor.

Where courts have taken the approach currently adopted by the Second Circuit, the linchpin has been that, based upon the guidance provided in Central Bank, a plaintiff cannot rely—without some additional duty of the secondary actor to speak—upon unstated assistance in another’s misstatement.

Other Contrivances

Where the basis for the securities fraud claim against the secondary actor is not mere participation in another’s statement (or omission), but instead some other fraudulent device, however, the law is growing less clear. In In re Parmalat Securities Litigation, 376 F.Supp.2d 472, 504 (SDNY 2005), Judge Lewis Kaplan held that a claim under §10(b) and Rule 10b-5 may be stated where “a defendant directly or indirectly used or employed a manipulative or deceptive device or contrivance,” and that under Rule 10b-5(a) and (c), no misstatement or omission by that defendant is required, so long as the defendant deliberately engaged in a fraudulent scheme.

On the facts before him, Judge Kaplan held that a bank’s securitization of “worthless” invoices, for which the issuer accounted improperly on its financial statements, was a sufficiently “deceptive” device or contrivance by the bank for purposes of §10(b). See also Simpson v. AOL Time Warner, Inc., 452 F.3d 1040, 1048 (9th Cir. 2006) (“[T]o be liable as a primary violator of §10(b) for participation in a ‘scheme to defraud,’ the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme.”).

Recently, the U.S. Court of Appeals for the Fifth Circuit took the opposite view. The court reversed class certification of Enron shareholders against three investment banks alleged to have violated §10(b) by engaging in various business transactions with Enron that enabled Enron improperly to account for certain liabilities and revenues. See Regents of Univ. of Cal. v. Credit Suisse First Boston (USA) Inc., No. 06-20856, 2007 WL 816518, at *9 (5th Cir. March 19, 2007). The Fifth Circuit held that an act cannot be “deceptive” under §10(b), even pursuant to Rule 10b-5(a) or (c), where “the actor has no duty to disclose.” The court reasoned that, “[p]resuming plaintiffs’ allegations to be true, Enron committed fraud by misstating its accounts, but the banks only aided [and] abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron’s shareholders.”

The Stoneridge Case

The Supreme Court granted certiorari in Stoneridge in order to resolve this question:

Whether this Court’s decision in Central Bank forecloses claims for deceptive conduct under §10(b) and Rule 10b-5(a) and (c), where respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation’s financial statements, but where respondents themselves made no public statements concerning those transactions.

In that case, a public company’s shareholders alleged that the company’s vendors were primarily liable under §10(b) and Rule 10b-5(a) and (c) for engaging in transactions with the company, knowing that the company intended to account for the transactions improperly. The district court dismissed these claims as “claims for aiding and abetting.” Because “[p]laintiffs do not assert that [the vendors] made any statement, omission or
action at issue or that plaintiffs relied on any statement, omission or action made by either of them.”

The U.S. Court of Appeals for the Eighth Circuit affirmed, holding that *Central Bank* and prior Supreme Court precedent stand for three principles dictating that conclusion:

1. The Court’s categorical declaration that a private plaintiff “may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of §10(b)” included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b).

2. A device or contrivance is not ‘deceptive,’ within the meaning of §10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose.

3. The term ‘manipulative’ in §10(b) has the limited contextual meaning ascribed in Santa Fe (i.e., specific illegal trading practices such as price-rigging).

The Eighth Circuit read the shareholders’ complaint as focusing on allegations of “deception,” i.e., that the company engaged in a scheme to publish materially misstated financial statements based on transactions with its vendors. The shareholders did not allege that the vendors made any misstatement upon which the shareholders relied, nor that the vendors were under a duty to speak to the shareholders, and thus, the court held, the vendors did not commit any deceptive act. At most, the court held, the shareholders alleged that the vendors deliberately aided and abetted the company’s deception.

**Conclusion**

If the Supreme Court rejects the Eighth Circuit’s reasoning and conclusion, and instead holds that §10(b) liability for “deceptive” practices under Rule 10b-5(a) and (c) extends to those who say nothing and have no duty to speak, the impact will be enormous.

First, it could undercut dramatically the import of *Central Bank’s* rejection of aiding and abetting liability. Second, the dividing line for liability in securities fraud litigation could move from a question of whether a “secondary actor” did or did not make a misstatement or omission to the more nebulous question of the extent of its relationship, level of business dealings and familiarity with the underlying “primary” actor.

Would an auditor be liable under §10(b) for reviewing—but issuing no opinion on—its client’s interim financial statements? Or would an underwriter be liable for statements in an offering document which explicitly indicates that the statements are those of the issuer alone? If the Supreme Court were to hold that such actions constitute securities fraud, it could represent a dramatic change for all secondary actors whose business touches the securities markets.

As the Eighth Circuit noted, “[d]ecisions of this magnitude should be made by Congress.” Indeed, *Stoneridge* presents the Supreme Court with an opportunity to reaffirm and clarify *Central Bank* by holding that by law and by common sense, an act is not “deceptive” under §10(b) unless it involves a false representation or an omission by someone who owes a duty to speak, i.e., acts upon which another person reasonably may rely.
"§10(b) Secondary Actor Liability: High Court to Resolve"

The New York Law Journal
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Sarah S. Gold and Richard L. Spinogatti

Since the U.S. Supreme Court abolished private aiding and abetting actions under §10(b) in Central Bank, the federal courts have struggled to define the boundaries of primary liability for secondary actors, persons doing business with issuers such as lawyers, accountants, bankers and suppliers.

Now, the U.S. Supreme Court has granted certiorari in a case that may define the standards for imposing §10(b) primary liability on secondary actors engaging in transactions that allegedly constitute deceptive devices, acts or schemes under Rule 10b-5. In re Charter Communications Inc. Securities Litigation, 443 F3d 987 (8th Cir. 2006), cert. granted sub nom. Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 2007 WL 879583 (March 26, 2007). The three appellate courts to address the issue have created a split of authority. The U.S. Court of Appeals for the Eighth Circuit and, most recently, the U.S. Court of Appeals for the Fifth Circuit in Regents of Univ. of Calif. v. Credit Suisse First Boston (USA), Inc., 2007 WL 816518 (5th Cir. March 19, 2007), have barred liability unless the secondary actor made misrepresentations, had a duty to disclose, or engaged in market manipulation. The U.S. Court of Appeals for the Ninth Circuit adopted a broad scheme liability standard in Simpson v. AOL Time Warner Inc., 452 F3d 1040 (9th Cir. 2006). Both the Supreme Court and Congress have recognized it is essential to have a uniform and decisive liability standard.

Background

In abolishing aiding and abetting claims by private litigants under §10(b) of the Securities Exchange Act of 1934, Central Bank held that “the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. . . . The proscription does not include giving aid to a person who commits a manipulative or deceptive act.” A secondary actor may only be subject to liability if that party “employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies . . ., assuming all of the requirements for primary liability under Rule 10b-5 are met.”

Private plaintiffs have since pressed creative arguments couching claims against secondary actors as primary liability, often alleging deceptive devices, schemes, or acts under Rules 10b-5(a) or (c), rather than material misrepresentations or omissions under Rule 10b-5(b). Courts have formulated conflicting tests for primary liability under those rules, seeking to define what it means to “indirectly” employ a “deceptive device” under §10(b).

The Circuits’ Conflicting Standards

The Eighth and Fifth circuits have rejected §10(b) claims asserted against, respectively, vendors and banks that allegedly engaged in sham transactions allowing the issuer to
misstate its financial condition. Both courts held, in the words of the Eighth Circuit, that the defendant must “make or affirmatively cause to be made a fraudulent misstatement or omission, or . . . directly engage in manipulative securities trading practices . . . [to] be held liable under §10(b) or any subpart of Rule 10b-5.” In re Charter Communications, 443 F3d at 992. As the Eighth Circuit explained, “[t]o impose liability for securities fraud on one party to an arm’s-length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress.” Id. at 992-93.

Similarly, the Fifth Circuit recently issued a decision in which the majority rejected §10(b) liability for banks alleged to have engaged in “irrational” transactions with Enron to inflate Enron’s revenues. Agreeing with the Eighth Circuit, the majority concluded that primary liability exists only where a party engaged in “deceptive” conduct, requiring either a misstatement or a failure to disclose by one with a duty to disclose or manipulation, a “term of art” requiring that a defendant directly engage in manipulative securities trading practices. Regents of Univ. of Calif., 2007 WL 816518 at *10. 12, 13. Since the banks made no misstatements, primary liability could attach only if the banks owed a duty of disclosure to the public (which they did not), since an act cannot be “deceptive” under §10(b) where the actor has no duty to disclose. Id. at *8, 9.

In contrast, the Ninth Circuit and other federal judges have struggled to establish a “deceptive device” standard not demanding either a misstatement or omission by the defendant which could be used to allege a broad “scheme to defraud.” Simpson, 452 F3d at 1049-50. In Simpson, as in Charter, the secondary actors were vendors engaging in allegedly sham transactions allowing Homestore.com to overstate revenues. Id. at 1042-43. The SEC advocated defining a deceptive act broadly: “engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues.” Id. at 1048. The Ninth Circuit adopted a variant of that test: “to be liable as a primary violator of §10(b) for participation in a ‘scheme to defraud,’ the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme.” The Court emphasized “[i]t is not enough that a transaction . . . had a deceptive purpose and effect; the defendant’s own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect.” Id. What types of secondary actor conduct might meet that test (which would obviously necessitate a fact-intensive inquiry) remains unclear, as the complaint was found not to state a claim under this standard? Id. at 1054.

The Fifth Circuit in Regents specifically rejected the Ninth Circuit’s theory of “scheme” liability as contrary to Supreme Court precedents establishing that “a device, such as a scheme, is not ‘deceptive’ unless it involves breach of some duty of candid disclosure.” 2007 WL 816518 at *12 & n.30. Judge James L. Dennis, concurring, found the Court’s narrow interpretation “neither compelled nor justified by Supreme Court precedent.” Observing that the Court’s test “immunizes a broad array of undeniably fraudulent conduct . . . effectively giving secondary actors license to scheme with impunity, as long as they keep quiet.” he
favored the broad scheme liability standard of the Ninth Circuit, the SEC, and District Judge Lewis Kaplan in *In re Parmalat Securities Litigation*, 376 FSupp2d 472 (SDNY 2005). *Id.* at *21, 22.

**Crafting a Proper Standard**

Although some courts have been concerned that participants in sham transactions entered into with scienter and a deceptive "purpose and effect" not escape §10(b) liability, the Supreme Court in *Central Bank* made clear that, regardless of policy arguments, the language of the statute controls. *511 US* at 173-75, 188. Given the statutory language, the only way to craft a standard of primary liability for those who have not themselves made a misstatement and who have no duty to speak would be to posit that the "directly or indirectly" language of §10(b) allows liability for those who "indirectly" employ a "deceptive device." However, that argument is no more effective for primary claims than it was when raised in support of aiding and abetting liability. *Central Bank* rejected that very argument because for a secondary actor to have primary liability, that party must engage in the proscribed acts (at least indirectly) but aiding and abetting liability "extends beyond persons who engage, even indirectly, in a proscribed activity; [it] reaches persons who do not engage in the proscribed activity at all, but who give a degree of aid to those who do." *511 US* at 176. And, it would allow liability without the requisite reliance upon the secondary actor’s own statements or actions. *Id.* at 180. The same analysis is equally true for the allegedly sham business transactions at issue in these secondary actor cases.

Consequently, scheme liability seems to run afoul of the *Central Bank* principles, as it would allow liability against third parties who did not engage in the proscribed activity of making a material misrepresentation or actionable omission and the investing public could not have relied on any statements or omissions of those parties. The only sure way to follow *Central Bank* is the bright-line rule of the Fifth and Eighth circuits—that a defendant cannot be liable in a private action under §10(b) without making a misstatement or actionable omission.

**Supreme Court Resolution**

The question of secondary actor liability under §10(b) is now squarely (once again) before the Supreme Court in *Charter*. The question presented is whether *Central Bank* forecloses claims of deceptive conduct where, although the vendors made no public statements, they engaged in transactions with no legitimate business or economic purpose except to inflate artificially *Charter*’s financial statements. The answer will be dispositive of the Ninth and Fifth circuit cases as well, as the secondary actor defendants in each of those cases also did not participate in making the misstatement constituting the alleged violation, did not owe any duty to the investing public, and engaged in nonsecurities transactions with issuers that made the statements constituting the violation. . . .
"Government Wants Securities Liability Limited"

SCOTUSBlog.com
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Lyle Denniston

Switching sides in a major fight over securities law, the Bush Administration on Wednesday told the Supreme Court that the government generally opposes liability for third parties in fraud lawsuits if there is no proof that they directly deceived investors who were counting on them for solid information. The liability issue involves entities such as investment bankers who act as business partners to a firm that directly engages in deception or manipulation of securities. . . . The government thus abandoned a substantial part of a position it had held in prior cases in support of investors; the brief also contradicted the majority of the present members of the Securities and Exchange Commission, and the chairmen of leading financial and other committees in Congress. Clement resisted a strenuous lobbying effort by lawmakers to stay on the sidelines if he could not support investors.

The brief that finally emerged from weeks of maneuvering and lobbying had some of the characteristics of a compromise, but ultimately employed language that suggested that third-party liability should be difficult to prove, absent clear evidence of reliance by investors on any misconduct by such other parties.

Filed in Stoneridge Investment v. Scientific-Atlanta (06-43), a case scheduled for oral argument on Oct. 9 in the new Term, the brief urged the Court to uphold a ruling by the Eighth Circuit Court that broadly insulated third parties from liability for securities deception or manipulation. Clement, however, argued that the Eighth Circuit had gone too far in its curb on third party liability. The decision nevertheless should be upheld, the Solicitor General argued, because there was no proof that any deception in the Stoneridge case by third parties was relied upon by investors. The Circuit Court was wrong, the brief said, in concluding that a third party that had some role in a deceptive scheme can never be held liable for someone else’s fraud if the third party did not make a misstatement or an omission that it had a duty to disclose or did not directly engage in manipulating trading. Deception can occur by means short of that, the brief said.

The dispute turns, at least in part, on the meaning of a 1994 Supreme Court ruling, in Central Bank v. First Interstate Bank; there, the Court barred private securities fraud claims based on assertions of aiding and abetting fraud by others. Making third parties liable for a role in someone else's fraud, absent proof that investors relied on third party conduct, the Solicitor General contended, would be “the functional equivalent” of aider-abettor liability in suits filed by private investors. Seeking to build on the 1994 precedent, Clement’s new brief argued that “it would greatly expand the inferred private right of action under Section 10(b) and Rule 10b-5 if ‘secondary actors’ could be held primarily liable whenever they engage in allegedly deceptive conduct, even if investors do not rely on (and are not even aware of) that conduct. Such a rule would expose not only

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accountants and lawyers who advise issuers of securities, but also vendors (such as respondents) and other firms that simply do business with issuers, to potentially billions of dollars in liability when those issuers make misrepresentations to the market. Such a rule would thereby considerably widen the pool of deep-pocketed defendants that could be sued for the misrepresentations of issuers, increasing the likelihood that the private right of action will be 'employed abusively to impose substantial costs on companies and individuals whose conduct confirms to the law.'"

Although Clement refused to put the current SEC majority’s opposing view before the Court, as the commissioners had asked him to do, their views have been offered to the Court in filings by members of Congress, who have asked permission to join in the Stoneridge case.

The filing of the brief ended weeks of public and private dispute over what role, if any, the government would be playing in the Stoneridge case, and in another case, raising the same issue, that the Supreme Court has yet to act upon—the case of California Regents v. Merrill Lynch, et al. (docket 06-1341), which involves billions of dollars in potential liability for major investment banking houses in a part of the Enron scandal. The Fifth Circuit, like the Eighth, rejected “scheme liability” for third parties. Clement had declined in June when asked by the SEC to file a brief supporting Stoneridge. Since then, the lingering question was whether the government would stay out of the case entirely, or side with third parties—as President Bush and Treasury Secretary Henry Paulson have been pressing Clement to do.

Clement’s brief made a slight bow to the value of investor lawsuits, saying that “meritorious private actions are an essential supplement to criminal prosecutions and civil enforcement actions brought by the government.”

But, he went on, “private securities actions can be abused in ways that impose substantial costs on companies that have fully complied with the applicable laws. The United States . . . has responsibility, through . . . the federal banking agencies, for ensuring that entities providing services to publicly traded companies are not subject to inappropriate secondary liability.”

The brief’s challenge to the scope of the Eighth Circuit ruling against “scheme liability” focused on the lower court’s exclusion of broad categories of third-party conduct from securities fraud liability. The Solicitor General went so far as to say that, since the Circuit Court was wrong about that, it may well be true that the third parties in the Stoneridge case actually did engage in deception in violation of the law against securities manipulation. If a third party itself engages in deceptive conduct, that could lead to liability.

“Contrary to the view seemingly expressed by the court of appeals,” the brief argued, “Section 10(b)’s prohibition against deception is not limited to actual misstatements or omissions, but encompasses non-verbal deceptive conduct as well.”

The Solicitor General went on, however, to say that investors claiming a third party shared in “scheme liability” should have to show, in addition to deception, that investors or others had actually relied upon the third parties’ acts of deception. In the Stoneridge case, Clement said, the investors do not allege that they were even aware of the transactions that the third parties engaged in
along with the alleged primary violator.

He added: "Allowing liability for a primary violation under the circumstances presented here would constitute a sweeping expansion of the judicially inferred private right of action in Section 10(b) and Rule 10b-5. . . ."
The New York Futures Exchange’s Committee for the Pacific Stock Exchange Technology Index Futures Contract & Options was responsible for calculating the price of P-Tech contracts to calculate margin requirements. Norman Eisler, Chairman of the NYFE and member of the NYFE’s Settlement Committee, allegedly manipulated the settlement prices of P-Tech contracts to benefit his own security. Klein, in response to those manipulations, miscalculated the margin requirements for the First West Trading account to be $700,000, of which Eisler was the principal. First West was unable to cover the margin and the resulting illiquidity of the P-Tech contracts caused Klein to request the NYFE Board to halt trading in P-Tech contracts, which NYFE declined to do. Eisler was then removed from the Committee, the settlement prices were recalculated, and First West’s requirement increased to $4.5 million. First West could not meet the requirement, resulting in Klein taking a charge against their net capital, which put Klein below the minimum required net capital for the New York Clearing Corporation and the New York Mercantile Exchange. Both organizations suspended Klein’s membership, which caused Klein to collapse. Klein sued on grounds that the NYFE failed to enforce its rules and other state law claims. The New York Board of Trade and Eisler moved to dismiss for lack of standing, which the district court granted and Second Circuit affirmed.

Questions Presented: Whether the court of appeals erred in concluding that futures commission merchants lack statutory standing to bring suit because the court found they were not involved in the transactions in question.
United States District Court for the Southern District of New York (Daniels, J.) for lack of standing to bring claims against Defendant-Appellees the Board of Trade of the City of New York ("NYBOT"), New York Clearing Corporation ("NYCC"), Norman Eisler, and others (collectively "NYBOT Defendants") under Sections 22(a) and (b) of the Commodity Exchange Act (CEA), 7 U.S.C. § 25. After dismissing Klein's claims under the CEA, the district court declined to exercise jurisdiction over its supplemental state law claims and dismissed them without prejudice. The NYBOT defendants cross-appeal that dismissal. For the reasons set forth below, we affirm. Except as noted, the facts are drawn from the complaint.

As a FCM, Klein facilitated the trading and fulfilled certain obligations of its customers who traded through the NYBOT. Prior to May 2000, Defendant Norman Eisler, whose conduct is the focus of Klein's complaint, was the Chairman of the New York Futures Exchange ("NYFE"). The NYFE is a futures and options exchange designated by the Commodity Futures Trading Commission ("CFTC") as a contract market for the trading of commodities futures and options, including P-Tech Futures and Options ("P-Tech contracts"). Eisler was also a member of the NYFE's Settlement Committee for the Pacific Stock Exchange Technology Index Futures Contract & Options (the "Committee"). The Committee's primary responsibility was to calculate the price of P-Tech contracts for the purposes, among other things, of calculating margin requirements in customers' accounts. Eisler was also a customer of Klein and the principal of First West Trading Inc. ("First West"), another Klein customer. Eisler traded in P-Tech contracts for the account of First West. The trades were unsolicited and were made without input or advice from Klein.

Allegedly, Eisler, in his capacity as a member of the Committee, secretly manipulated the settlement prices of P-Tech contracts. This manipulation benefited Eisler's P-Tech positions but, at the same time, caused Klein to miscalculate the margin requirements for the First West account. Around March 2000, the NYBOT began receiving complaints regarding the P-Tech settlement prices but failed to make proper inquiries or to place Klein or other members of the industry or public on notice of potential irregularities.

In early May 2000, Klein, based on the incorrect settlement prices, computed the required margin in First West's account at $700,000, but Eisler was unable to post that amount. Klein then contacted the NYBOT and expressed concerns regarding the illiquidity of the P-Tech contracts, Eisler's inability to meet First West's margin call, and his inability to liquidate First West's contracts. Klein reported that the First West margin deficit, if not covered, would impair Klein's net capital and cause Eisler significant losses. Klein requested that the NYFE Board halt trading in P-Tech contracts, but no such action occurred.

At that point, the scheme began to unravel. In mid-May, Eisler's NYBOT membership privileges were suspended and he was dropped from the Committee. Once this occurred, the remaining Committee members recalculated the settlement prices and First West's margin deficit ballooned to $4.5 million, an obligation it could not meet. As a result, Klein was required to take an immediate charge against its net capital, forcing it below the minimum required for clearing members of the NYCC and the New York Mercantile Exchange ("NYMEX"). Its membership privileges were suspended and Klein collapsed.
Klein then sued on various claims. Klein's first claim alleged that NYFE violated § 5b of the CEA by failing to enforce its rules, and sought a declaration that NYFE should be suspended as a contract market. Klein further alleged that the NYBOT Defendants violated the anti-fraud provisions in CEA § 4b and 17 C.F.R §§ 33.9 and 33.10, and the insider provisions of CEA § 9. In addition, the complaint alleged a variety of state law claims.

The NYBOT Defendants moved to dismiss principally on the ground that Klein was not a purchaser or seller of futures contracts or options and, therefore, lacked standing under § 22 of the CEA. They also moved to dismiss Klein's state law claims with prejudice on the ground that they were preempted by the CEA. The district court agreed and dismissed Klein's claims under the CEA for lack of standing. Specifically, the district court concluded:

Plaintiff Klein lacks standing under Section 22 to bring this suit. Klein does not allege that it was either a purchaser or a seller of P-Tech Futures and Options. Furthermore, Klein does not claim that it traded for its own account. Rather, it is undisputed that First West, not Klein, traded in P-Tech Futures and Options. Indeed, Klein claims that these trades were effected "without input, counsel, advice or any type of recommendation whatsoever from Klein & Co." Klein further alleges that it "had no equity or financial interest in the First West account nor did Klein & Co. exercise control over the trade in said account."

Klein & Co. Futures v. Bd. of Trade, No. 00-CV-5563-GBD, 2005 WL 427713, at *4 (S.D.N.Y. Feb. 18, 2005 (internal citations omitted)).

The court further reasoned that § 22 precluded an action by a plaintiff that "did not suffer its damages in the course of its trading activities on a contract market." Id. Without addressing preemption, the district court declined to exercise supplemental jurisdiction over the state law claims and dismissed them without prejudice. This appeal followed.

II. DISCUSSION

We review de novo the district court's dismissal of a complaint for lack of standing under Fed.R.Civ.P. 12(b)(1) and 12(b)(6). See Kaliski v. Bacot (In re Bank of N.Y. Deriv. Litig.), 320 F.3d 291, 297 (2d Cir. 2003). We review the court's decision to decline supplemental jurisdiction over state law claims for abuse of discretion. See Valencia ex rel Franco v. Lee, 316 F.3d 299, 304 (2d Cir. 2003).

A. Standing under § 22 of the CEA

CEA § 22 enumerates the only circumstances under which a private litigant may assert a private right of action for violations of the CEA. Section 22 includes two types of claims. Section 22(a) relates to claims against persons other than registered entities and registered futures associations. 7 U.S.C. § 25(a). Section 22(b) deals with claims against those entities and their officers directors, governors, committee members and employees. The text of the two subdivisions requires that a putative plaintiff fall within one of the four required relationships set forth in § 22(a)(1)(A-D).

The common thread of these four subdivisions is that they limit claims to those of a plaintiff who actually traded in the commodities market. Specifically, the
remedies afforded by CEA § 22(b) are available only to a private litigant “who engaged in . . . transaction[s] on or subject to the rules of” a contract market. Id. § 25(b)(1)-(3). The section contains another important limitation. Subsection 22(b)(5) provides that the private rights of action against the exchanges enumerated in § 22(b) “shall be the exclusive remedy . . . available to any person who sustains a loss as a result of” a violation of the CEA or an exchange rule by a contract market or one of its officers or employees. Id. § 25(b)(5) (emphasis added).

Klein does not fall within any of the required subdivisions of § 22(a)(1)(A)-(D). To fit under one of the four, Klein must essentially either have (1) received trading advice from Eisler or First West for a fee; (2) traded through Eisler or First West or deposited money in connection with a trade; (3) purchased from or sold to Eisler or First West or placed an order for the purchase or sale through them; or (4) engaged in certain market manipulation activities in connection with the purchase or sale of a commodity contract.

Here, Klein was a FCM and a clearing member of the NYCC that cleared First West’s trades through NYCC. Klein does not contend that it purchased or sold P-Tech contracts. Klein was not a trader of P-Tech contracts; nor did it own the P-Tech contracts at issue. To the contrary, Klein’s complaint admits that it had no financial interest in the First West account and that all the trades in question were unsolicited by First West. Klein’s losses were not the result of its purchases or sales in the commodities market. Klein functioned merely as a broker or agent that earned commissions for handling its customers trades. As a clearing member, Klein cleared their trades and was obligated to post margins for them as required. Under NYCC Rules governing clearing members, Klein was liable for its own failure to post the required margin on its customers’ positions, whether or not Klein collected that margin from defaulting customers such as First West.

In view of the provisions of sections 22(a) and (b) expressly limiting the categories of persons that can seek remedies under the statute we conclude, as did the court below, that a plaintiff such as Klein who falls outside those categories lacks standing. See Water Transp. Ass’n v. ICC, 722 F.2d 1025, 1028-29 & n. 2 (2d Cir. 1983).

Klein’s main response to this reading of the statute is that the remedies of § 22 are not limited to those who actually traded and that it has standing because, as the legislative history demonstrates, Congress intended to protect those such as itself who were injured in the course of trading on a contract market. According to Klein, the legislative history shows that Congress’s main concern in drafting § 22 was to protect “market participants” who suffered actual losses arising from a transaction on the futures market. Klein contends that Congress intended the restrictions on standing to prevent suits on speculative damages to assets subject to price fluctuations on the commodities markets but which are not the subject of transactions. Affording standing to a FCM, such as Klein, is consistent with these purposes because a FCM that has experienced catastrophic losses, that were caused by a customer who had engaged in manipulation, has suffered what Congress had in mind: actual, non-speculative damages resulting directly from transactions on a commodities exchange.

This argument founders on the clear text of the statute. Section 22(b)’s remedies are expressly available only to a private litigant who “engaged in any transaction on or subject to the rules” of contract markets or other registered entities. As noted, Klein was not an
owner of P-Tech contracts traded by First West. To the contrary, Klein was required by NYCC Rules to keep the options in a segregated First West account and not to co-mingle assets. Klein did not fall within any of the categories enumerated in § 22(a)(1)(A-D). Because we conclude the statute is clear, we decline Klein’s invitation to parse the legislative history. See 7 U.S.C. § 25(a); Lee v. Bankers Trust Co., 166 F.3d 540, 544 (2d Cir. 1999) (“It is axiomatic that the plain meaning of a statute controls its interpretation and that judicial review must end at the statute’s unambiguous terms.” (internal citations omitted)).

In the alternative, Klein contends that it has standing under CEA to challenge the NYBOT Defendants as a “forced” purchaser and seller of securities. Klein contends that the Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), after confirming that the federal securities laws confer an implied private right of action, granted standing under § 10(b) of the Securities Act of 1934 to securities brokers as “forced” purchasers or sellers, in situations where they, as clearing members, suffered damages arising from obligations to guarantee their customers’ trades. Klein argues that as a FCM and clearing member, it was subject to federal statutes as well as the rules and by-laws of NYBOT, NYFE, and NYCC that required Klein to maintain funds guaranteeing its customers’ transactions on the contract market. In his brief on appeal, Klein asserts that it assumed “a very real investment risk that the commodity contracts its customers traded would maintain or increase in value, a risk that is identical to that taken by any purchaser or seller of a commodity contract who is granted standing under the CEA.” In sum, Klein argues that it has standing because it faced essentially the same risks as a purchaser or seller of commodities contracts. We disagree.

It is undisputed that Klein was not a trader of P-Tech contracts. Moreover, Klein did not own the P-Tech contracts at issue. Rather, First West, not Klein, traded in P-Tech contracts. Indeed, as the district court recognized, Klein stated in its complaint that it had no financial interest in the First West trading activity and had nothing to do with its trading decisions. Consequently, regardless of whether the First West trading position rose or declined in value, Klein had no interest in any of the resulting profits or investments losses. As the district court observed, “Klein suffered damages because of its customer First West’s inability to cover its margin call. . . .” Klein, 2005 WL 427713, at *4. Thus, Klein’s loss was a credit loss, not a trading loss.

Because § 10(b) and Rule 10(b)(5) are implied causes of action, their “boundaries are left to judicial inference.” Grace v. Rosenstock, 228 F.3d 40, 46 (2d Cir. 2000). The securities laws discussed in Blue Chip Stamps—§ 10(b) of the Securities Act of 1934 and Rule 10(b)(5)—contain no corollary to the express limitations on standing expressly imposed by CEA § 22(b). Section 22 was enacted as part of the Futures Trading Act of 1982 in response to Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 102 S.Ct. 1825, 72 L.Ed.2d 182 (1982), where the Supreme Court recognized an implied right of action under the CEA. In response, Congress enacted CEA § 22 but enumerated the only circumstances under which a civil litigant could assert a private right of action for a violation of the CEA or CFTA regulations. See H.R.Rep. No. 565, Pt. I, 97th Cong., 2d Sess. 57 (1982), reprinted in 1982 U.S.C.C.A.N. 3871. 3906. Congress went on to emphasize that the private right of
action in CEA § 22 “shall be the exclusive remedy . . . available to any person who sustains a loss as a result of” a violation of the CEA. 7 U.S.C. § 25(b)(5). Enforcing the statute that Congress wrote, we conclude Klein lacks standing because it was not “engaged in any transaction on or subject to the rules” of a contract market and did not suffer any “actual losses that resulted from such transaction” as required by § 22 of the CEA.

B. State Law Claims

After dismissing the claims under the CEA for lack of standing, the district court dismissed the supplemental state law claims without prejudice. The NYBOT Defendants, who had argued that the state law claims were preempted by the CEA, cross-appeal on the grounds that the district court should have dismissed Klein’s state law claims with prejudice on preemption grounds. We review this dismissal for abuse of discretion. See Valencia, 316 F.3d at 304.

It is well settled that where, as here, the federal claims are eliminated in the early stages of litigation, courts should generally decline to exercise pendent jurisdiction over remaining state law claims. See Kolari v. New York-Presbyterian Hosp., 455 F.3d 118, 122 (2d Cir. 2006)(“in the usual case in which all federal-law claims are eliminated before trial, the balance of factors . . . will point toward declining to exercise jurisdiction over the remaining state-law claims.”)(quoting Carnegie-Mellon Univ. v. Cohill, 484 U.S. 343, 350 n. 7, 108 S.Ct. 614, 98 L.Ed.2d 720 (1988)); Castellano v. Bd. of Trs., 937 F.2d 752, 758 (2d Cir. 1991). In deciding whether to exercise jurisdiction over supplemental state-law claims, district courts should balance the values of judicial economy, convenience, fairness, and comity—the “Cohill factors.” See Cohill, 484 U.S. at 350, 108 S.Ct. 614. The NYBOT Defendants contend that the district court should have retained jurisdiction to decide the important, quintessentially federal question of whether the state law claims are preempted by the CEA. See Baylis v. Marriott Corp., 843 F.2d 658, 665 (2d Cir. 1988)(“One factor that may sometimes favor retaining pendent jurisdiction is when a state claim is closely tied to questions of federal policy and where the federal doctrine of preemption may be implicated.”).

Because the decision to retain jurisdiction is discretionary and not a litigant’s right, a court is not required either to accept or decline supplemental jurisdiction when a state law claim raises federal preemption issues. See Kolari, 455 F.3d at 122; Valencia, 316 F.3d at 305 (“In providing that a district court ‘may’ decline to exercise such jurisdiction, [42 U.S.C. § 1367(c)] is permissive rather than mandatory.”); Baylis, 843 F.2d at 665 (concluding that the Cohill factors outweighed the federal preemption factor, and that the district court did not abuse its discretion in refusing to exercise supplemental jurisdiction). Following consideration of the Cohill factors, the proper course is left to the court’s discretion. See, e.g., Motorola Credit Corp. v. Usan, 388 F.3d 39, 56 (2d Cir. 2004). Our concern, therefore, is solely whether that discretion was abused and we find it was not.

III. CONCLUSION

For the reasons discussed, the judgment of the district court is AFFIRMED.
Today the Court granted cert. in *Klein & Co. Futures, Inc. v. Board of Trade of the City of New York*, No. 06-1265, a case involving the commodities futures trading market. In a prior post, we discussed the petition as an example of what practitioners can do when their case does not directly implicate a circuit split. The now-granted petition poses the following question: “Whether the court of appeals erred in concluding that futures commission merchants lack statutory standing to invoke that right of action because, in the court’s view, they do not engage in such transactions, despite the statutory requirement that the merchants enter into and execute their transactions on, and subject to the rules of, a board of trade and the fact of the merchants’ financial liability for the transactions.”

***

For those unfamiliar with commodities futures markets, a little background may be helpful. A commodities future is a contract to sell a particular commodity (say, frozen concentrated orange juice, as in the movie “Trading Places”) at a price set in the contract. The seller of the contract becomes obligated to provide the buyer with the promised amount of the commodity at the promised price on a set date in the future (say, 15,000 pounds of frozen concentrated orange juice for $1.500 on July 1, 2007). Someone who believes that the market price for frozen concentrated orange juice will be $2,000 per 15,000 pounds might buy this hypothetical futures contract for $250, since if the guess about the future price turns out to be correct, the contract will save the purchaser $500 off the market price. Even people who don’t really want 15,000 pounds of frozen orange juice might buy such a contract, because they can then turn around and sell the money-saving contract to someone who actually does want it, and make a profit. The futures market is thus a place where some people buy futures contracts as a way of making money based on their bets about the future prices of commodities, and others buy contracts in order to protect themselves against fluctuations in the prices of commodities they need to run their businesses.

Futures contracts are sold in commodity exchanges, which are operated by a board of trade such as the respondent in this case, the Board of Trade of the City of New York. Much like the stock market, actual trades on the commodity exchanges are conducted through intermediaries, in this case, a commodity futures merchant. The merchant, like a stock broker, takes orders from customers and purchases or sells futures contracts on its customers’ behalf.

This whole process is governed by the rules of the relevant board of trade, which is required by the Commodities Exchange Act to promulgate and enforce rules governing exchanges on its market. The Act also provides a cause of action for violations of the Act, including suits against the boards themselves for failing to enforce their rules.

Among other things, the boards enact rules governing the sale of futures contracts “on margin.” As in the stock market, merchants can allow customers to buy futures contracts
while giving the merchant only a small percentage of the full cost of the transaction. If the market price changes too much during the life of the contract, the customer may be subject to a "margin call" and required to pay the merchant more money in order to reduce the risk that the customer will not have enough money to pay any possible loss on the contract when it becomes due. If the margin call is not met, the merchant may immediately liquidate the customer's holdings.

Whether or not a margin call is required is determined by the daily "settlement price" for the commodity. The settlement price approximates the market price for that day and is set by the board of trade. Because some commodities are infrequently traded, it is not always possible to simply look at the price for the commodity in that day's trading in calculating the settlement price. Accordingly, some degree of judgment and expertise is required, a process that is subject to manipulation, which leads us to the facts of this case.

The lawsuit in this case arose from the alleged manipulation of the futures market process by an official of the respondent Board of Trade of the City of New York. According to the plaintiffs, the chairman of one of the board's divisions owned a company that had purchased a lot of a specific futures contract through petitioner Klein & Co. Futures, a futures merchant on the Board of Trade of the City of New York. It turns out that this was a bad investment. When it looked like his company was going to be required to come up with substantial "margin call" payments or risk having their contracts liquidated at a loss, the chairman manipulated the daily settlement price for the futures. This worked for a while, but the scheme eventually fell apart, the settlement price readjusted to accurately reflect market conditions, and a $700,000 margin call was issued. The chairman's company didn't have the money to make the margin call, so Klein was forced to sell the futures, at a huge loss which Klein was required to absorb, leading to the collapse of that company as well.

Klein subsequently brought suit against the Board of Trade for failing to enforce its rules that should have prevented the chairman from manipulating the daily settlement price.

The issue before the Supreme Court is whether the Commodities Exchange Act permits a merchant (as opposed to its customers) from suing a board of trade for failing to enforce its rules. Section 25(b)(1) of the Act provides that "a licensed board of trade that fails to enforce any bylaw, rule, regulation, or resolution that it is required to enforce . . . by a person who engaged in any transaction on or subject to the rules of such registered entity to the extent of such person's actual losses that resulted from such transaction and were caused by such failure to enforce or enforcement of such bylaws, rules, regulations, or resolutions." The court of appeals held that merchants cannot sue under this provision because they do not "engage[] in any transaction" on the exchange; only their customers do, the court concluded. Klein contests this proposition, arguing that merchants in fact engage directly in exchanges in commodities markets on behalf of their customers and that Congress intended the Act to extend to both customers and their brokers. The Board of Trade has argued that Congress carefully worded the statute to limit the scope of the private right of action in a way that excludes merchants.
NEW YORK—The financial default of a futures brokerage this week has now spurred a lawsuit pitting this city’s two major commodity exchanges against one another.

The New York Mercantile Exchange and 15 of its members sued the New York Board of Trade over NYBOT’s handling of Klein & Co. Futures Inc.’s drop below minimum margin requirements.

The NYBOT, parent of both the New York Cotton Exchange and the Coffee, Sugar & Cocoa Exchange, shuttered its cotton and orange-juice trading for two hours Tuesday after announcing that Klein no longer had the $2 million on deposit required to guarantee the trades of floor members who held accounts with the firm.

But NYMEX traders also held accounts at Klein, and now that oil-and-metals exchange is claiming the NYBOT knew of the brokerage’s problems earlier than it let on. The NYMEX is also accusing its neighbor of improperly using NYMEX members’ money to cover the loss of a NYBOT trader.

The lawsuit means Klein’s woes have now quickly turned what was a quiet rivalry into a loud showdown between two markets located just few minutes’ walk apart on either side of the World Trade Center’s twin towers.

“I think this takes a lot of nerve, given how quickly and expeditiously we’ve handled this situation,” NYBOT President and Chief Executive Officer Mark D. Fichtel said of the lawsuit.

In its suit, [Klein & Co. Futures, Inc. v. Board of Trade of the City of New York.] filed in U.S. district court in Manhattan, NYMEX and its members seek a temporary order forbidding the NYBOT to use “innocent” Klein customer funds to satisfy the debts of the unnamed trader whose losses set off the turmoil.

Both sides agree those losses happened on NYBOT’s cotton-exchange division. But when they took place, who knew first, and what notification was given have become contentious questions.

“We believe strongly in the sanctity of the obligations of the clearing house to its customers,” NYMEX President R. Patrick Thompson said, referring to NYBOT’s obligations. “That’s the message we’re trying to send here.”

Neither exchange had precisely calculated the pivotal Klein account holder’s losses, although Mr. Thompson estimated them to be about $6 million. He estimated that about 56 members on NYMEX’s two divisions, including the Comex market where the nation’s benchmark gold futures trade, had accounts at Klein. He said most of the firm’s other 150 or so clients were at the NYBOT, which is the country’s major tropical-commodity exchange.

An unidentified man who answered the
phone at Klein refused to comment.

The NYBOT announced it would form a fund to compensate innocent members of both exchanges as soon as possible, a move Mr. Fichtel said demonstrates how unnecessary it was for NYMEX to file suit. “We’re just waiting on the accounting to figure out who the innocent parties are and how much each should receive,” Mr. Fichtel said. “The irony is that we need to get the accounting information from NYMEX.”

Both he and Mr. Thompson agreed it isn’t uncommon for a clearing corporation to have to use other customers’ pooled money to cover extreme losses by an individual trader. But Mr. Thompson said the NYMEX believes the NYBOT had sufficient advance notice as a marketplace that both collects trading information and has its own internal clearing division. Using that information, NYMEX’s suit alleges that NYBOT and its directors are acting in their own “self-interest” instead of the interests of Klein’s account holders. . . .
NEW YORK—A famous never-say-die New Yorker once said it ain’t over until it’s over. And for the New York Board of Trade these days, it never seems to be over.

“It,” in this case, is the fallout from the May collapse of a NYBOT trade-processing firm, Klein & Co.

Early last week, NYBOT settled a lawsuit with the neighboring New York Mercantile Exchange to ensure that NYMEX members who also were Klein account holders would be reimbursed fully.

But now Klein itself has checked in with a $100 million lawsuit of its own against the NYBOT, blaming the exchange and its executives for Klein’s collapse.

According to the suit, filed in U.S. District Court in Manhattan, Klein’s losses originated with a NYBOT division chairman who had maintained artificially low margins with Klein, partly by helping to falsify market quotations.

When those quotes were corrected, it led to a catastrophic margin call that shut Klein down and halted some NYBOT trading pits—but only after what the brokerage firm describes in the suit as a lackadaisical crisis response by exchange senior management.

Fundamentally, the accusations are similar to the ones that NYMEX levied, but with the bite of increased detail, Klein has essentially lent names, dates and dollar totals to the perception that NYBOT was truly to blame.

“The acts and omissions of the defendants consisted of a complete failure of market surveillance, failure in bad faith to take required action, a complete failure to maintain an orderly market, and bad-faith attempts to support a collapsed, illiquid, contrived, marketplace,” Klein says in the lawsuit filed by attorney Mark J. Alonso.

A spokesman for the NYBOT, which owns the Coffee, Sugar & Cocoa Exchange and the New York Cotton Exchange, declined to comment on the complaint.

Mr. Alonso said in an interview that Klein is seeking $75 million in punitive damages and $25 million in compensation from NYBOT. He couldn’t estimate how long the suit could take to play out.

At the heart of Klein’s accusations is Norman Eisler, a former customer who served as chairman of the New York Futures Exchange division of the cotton exchange.

According to the lawsuit, Mr. Eisler and members of a committee responsible for posting daily settlement prices kept those quotes artificially low for contracts on the Pacific Exchange’s technology index in the days leading into the default.

Mr. Eisler couldn’t be reached for comment last week.

Klein officials claim in the suit that they contacted NYBOT Executive Vice President
Joseph O’Neill about the “P-tech” index’s trading problems and the likelihood that Mr. Eisler’s firm wouldn’t be able to meet coming margin calls.

“Despite Klein’s request and in spite of the pending circumstances, no one at NYBOT . . . requested that the NYFE board convene to review the circumstances,” the suit says.

At that point, though, Mr. Eisler ceased to participate in calculating the “P-tech’s” settlement, and it was finally corrected on May 15, the lawsuit adds.

That, however, also triggered a recalculation of Mr. Eisler’s margin requirements at Klein, leaving his firm $4.5 million in debt the same day, according to the suit. Klein, which, as a clearer, guarantees the viability of its clients’ trades, then had to use $2.65 million of its own funds to cover the deficit, leaving it below the exchange’s $2 million margin requirement.

On May 16, the NYBOT publicly announced Klein’s meltdown. The exchange also shut down trading on the entire cotton exchange division while Klein’s other clients scrambled to find other clearing members to take their accounts . . .

(06-457)

Ruling Below: (Rowe v. New Hampshire Motor Transport Ass’n., 448 F.3d 66 (1st Cir. 2006), cert. granted, ___ S.Ct. __, 2007 WL 1802122 (U.S.), 75 USLW 3694, 75 USLW 3689).

The Federal Aviation Administration Authorization Act of 1994 ("FAAAA") states that "a State may not enact or enforce a law related to a price, route, or service of any motor carrier," or of any air carrier, with respect to the transportation of property. 49 U.S.C. §§ 14501(c)(1) & 41713(b)(4)(A). The FAAA, and these sections in particular, were intended to create uniform regulations across states by preempting any state law. In the current case, Maine’s Tobacco Delivery Law was created in response to increasing tobacco sales over the internet, which can be shipped through the mail or by commercial carriers. Maine’s law is an attempt to make sure that tobacco is not sold to minors over the internet. The First Circuit ruled that the FAAA preempted Maine’s Tobacco Delivery Law to the extent that the Maine law determined how a carrier must deliver packages with tobacco.

Questions Presented: (1) Whether the Federal Aviation Administration Authorization Act of 1994 ("FAAAA"), 49 U.S.C. §14501(c)(1) and 41713(b)(4)(A), preempts states from exercising their historic public health police powers to regulate carriers that deliver contraband such as tobacco and other dangerous substances to children; (2) Whether the FAAA preempts states from exercising their historic public health police powers to require shippers of contraband such as tobacco and other dangerous substances to utilize a carrier that provides age verification and signature services to ensure that such substances are not delivered to children.

NEW HAMPSHIRE MOTOR TRANSPORT ASS’N
Plaintiffs, Appellees

v.

G. Stephen ROWE, as Attorney General for the State of Maine
Defendant, Appellant

United States Court of Appeals
for the First Circuit

Decided May 19, 2006

[Excerpt: Some footnotes and citations omitted.]

HOWARD, Circuit Judge.

In 2003, Maine enacted a law to restrict and regulate the sale and delivery of tobacco products purchased via the internet or other electronic means. Several trade associations, representing air and motor carriers of property, brought this action against the
Maine Attorney General alleging that certain provisions of this law are preempted by the Federal Aviation Administration Authorization Act of 1994 (FAAAA). The district court granted summary judgment for the associations and enjoined Maine’s Attorney General from enforcing the law. We affirm in all respects but one.

I.

A. The FAAAA

There are two FAAAA preemption provisions at issue in this case. See Pub. L. No. 103-305, § 601; 108 Stat. 1569. The first provides that a “State . . . may not enact or enforce a law . . . related to a price, route, or service of any motor carrier . . . with respect to the transportation of property.” 49 U.S.C. § 14501(c)(1). The second states that a “State may not enact or enforce a law . . . related to a price, route, or service of an air carrier or carrier affiliated with a direct air carrier through common controlling ownership when such carrier is transporting property by aircraft or by motor vehicle.” 49 U.S.C. § 41713(b)(4)(A).

These provisions combine to bar states (subject to certain exceptions discussed later) from enacting laws related to prices, routes, or services of air or motor carriers of property. They are “intended to function in the exact same manner with respect to [their] preemptive effects.” H.R. Conf. Rep. 103-677 at 85, reprinted in 1994 U.S.C.C.A.N. at 1757.

B. The Maine Tobacco Delivery Law

In 2003, the Maine Legislature adopted “An Act to Regulate the Sale of Tobacco Products and to Prevent the Sale of Cigarettes to Minors.” See L.D. 1236 (121st Maine Leg.) (codified at 22 M.R.S.A. §§ 1551, 1555-C & 1555-D) (Tobacco Delivery Law). The Tobacco Delivery Law was prompted by the recent increase in internet tobacco sales which are consummated by direct delivery to consumers through the mail or by commercial carriers. See Testimony of Representative Glen Cummings Before the Joint Standing Committee on Health & Human Services (Apr. 29, 2003). This phenomenon has complicated Maine’s efforts to regulate “the sale of tobacco products to minors” and caused it to lose “tremendous tax revenues as a result of tax free sales by unlicensed companies.” Id. The associations persuaded the district court that §§ 1555-C(3)(C) & 1555-D are preempted by the FAAAA.

1. § 1555-C(3)(C)

Maine’s Tobacco Delivery Law permits a licensed tobacco retailer to sell tobacco products directly to consumers via the internet or other electronic means so long as the retailer takes specified steps to ensure that sales are not made to minors. See id. §§ 1555-C(2) & (3). One such step requires the retailer to use a carrier that will ensure that: (1) the purchaser of the tobacco products is the same person as the addressee of the package; (2) the addressee is of legal age to purchase tobacco products and sign for the package; and (3) if the addressee is under 27 years of age, that she show a valid government-issued identification verifying that she is old enough to purchase tobacco products. Id. § 1555-C(3)(C). Penalties are imposed only against the retailer for violations of this provision. See id. §§ 1555-C(3)(E)&(F).

2. § 1555-D

Section 1555-D makes it illegal for any
person to knowingly deliver tobacco products to a Maine consumer if the products were purchased from an unlicensed retailer. The section also states that a person delivering a package “is deemed to know” that the package contains tobacco products if it (1) so indicates on any side other than the side directly opposite the label, see Code of Me. R. ch. 203, § 11, or (2) was shipped by a person listed by the Attorney General as an unlicensed tobacco retailer.

C. The Effect of the Tobacco Delivery Law on United Parcel Service (UPS)

As discussed in further detail below, one way for the associations to prove that the challenged provisions of the Tobacco Delivery Law are preempted by the FAAAA is to demonstrate that they have a forbidden significant effect on carrier services. See infra at 25. The associations have attempted to make this showing by highlighting the effect of the challenged provisions on UPS, a motor/air carrier of property operating in Maine.

UPS, which delivers approximately 65,000 packages per day in Maine, offers door-to-door delivery service of packages and delivery of packages on an express basis. Its delivery operations function as an integrated system, requiring extensive planning and coordination among its operating facilities and ground and air fleet. Delays and disruptions in the sorting and delivery of packages can affect the timely delivery of thousands of packages within the UPS system.

Prior to the enactment of § 1555-C(3)(C), UPS did not require that its drivers deliver a package only to the addressee, and it did not require a signature from the recipient of the package unless the shipper paid a premium for this additional service. UPS determined that it would not be feasible to alter its delivery operations to provide these new services in Maine, so it stopped delivering all tobacco products to Maine consumers. To make deliveries of tobacco products to licensed retailers and distributors in Maine as permitted by § 1555-D, UPS now has modified its uniform package delivery procedures to identify packages that contain tobacco products. UPS requires that its pre-loaders in Maine (the employees who place the packages on the trucks for delivery) specially examine each package to determine if it is marked as containing tobacco or if the name of the addressee or shipper indicates that the package likely contains tobacco. Packages identified as likely containing tobacco products are then segregated so that UPS employees can research whether the package is destined for a licensed tobacco retailer or distributor. If UPS determines that the addressee is not a licensed tobacco retailer or distributor it arranges to return the package to the shipper or otherwise to dispose of the package.

D. The District Court Decision

Proceeding from the premise that the FAAAA preempts a state law if it “expressly references” a carrier’s prices, routes, or services or has a “forbidden significant effect” on the same, the district court concluded that the challenged provisions of the Tobacco Delivery Law are preempted by the FAAAA. See N.H. Motor Transp. Ass'n v. Rowe, 377 F. Supp. 2d 197, 210 (D. Me. 2005)(citing United Parcel Serv., Inc. v Flores-Galarza, 318 F.3d 323, 334-35 (1st Cir. 2003)(UPS I)). The court determined that, while § 1555-C(3)(C) did not expressly reference carrier services because that section is directed only at retailers of tobacco products, it has a forbidden
significant effect on UPS because, for the carrier to accept packages containing tobacco for delivery in Maine, it would have to adopt procedures that would "alter [its] delivery practices" for these packages. Id. at 216.

The court also ruled that § 1555-D both expressly references and has a forbidden significant effect on carrier services. It concluded that the provision expressly references services because it prohibits carriers from delivering a certain class of tobacco products, i.e., tobacco products purchased by Maine consumers from unlicensed retailers. See id. at 211-12. It also concluded that the provision also has a forbidden significant effect because it forced UPS to depart from "its nationally uniform procedure" by inspecting each package to identify the contents. Id. at 212. The Attorney General timely appealed from this ruling.

II.

A. Jurisdiction

Before reaching the merits of the Attorney General's appeal, we consider two threshold jurisdictional issues. The Attorney General asserts that the associations lack standing and that the action is moot in light of events occurring subsequent to the noticing of the appeal.

1. Standing

The associations invoke the representational standing doctrine recognized by the Supreme Court in Hunt v. Washington State Apple Adver. Comm'n. 432 U.S. 333, 343. 97 S. Ct. 2434, 53 L. Ed. 2d 383 (1977). Under this doctrine, "an association has standing to bring suit on behalf of its members when: (a) its members would otherwise have standing to sue in their own right; (b) the interests it seeks to protect are germane to the organization's purpose; and (c) neither the claim asserted nor the relief requested requires the participation of individualized members in the lawsuit." Id.

The Attorney General focuses his argument on the third Hunt factor. He contends that evidence concerning the effect that the challenged provisions of the Tobacco Delivery Law have on UPS suffices only to justify preemption of the challenged provisions as to UPS. Preemption against other carriers should occur only to the extent that the other carriers individually prove that the challenged provisions have a forbidden significant effect on their prices, routes, or services.

The district court rejected this argument, observing that "[a]ssociational standing is . . . granted in cases seeking injunctive relief rather than damages, because individualized proof is not necessary and the relief usually inures to the benefit of all members injured." N.H. Motor Transp. Ass'n v. Rowe, 324 F. Supp. 2d 231, 236 (D. Me. 2004). Because the associations only sought an injunction and a declaratory judgment against the challenged provisions, the court ruled that the third Hunt factor was satisfied. See id. at 236 (citing Playboy Enters., Inc. v. Pub. Serv. Comm'n of P.R., 906 F.2d 25, 35 (1st Cir. 1990)).

After the district court issued this ruling, we clarified the requirements for establishing the third Hunt factor. In so doing, we acknowledged that "there is no well developed test in this circuit as to how the third prong of the Hunt test . . . applies in cases where injunctive relief is sought." Pharmaceutical Care Mgmt. Ass'n v. Rowe,
But we did not embrace the proposition that, under *Playboy Enters.*, the third *Hunt* factor is always satisfied where an association seeks injunctive relief on behalf of all of its members. *See Rowe,* 429 F.3d at 314 ("*Playboy* is not an open door for association standing in all injunction cases where member circumstances differ and proof of them is important."). We concluded that representational standing is inappropriate if adjudicating the merits of an association’s claim requires the court to engage in a "fact-intensive-individual inquiry." *Id.* (quoting *Penn. Psychiatric Soc. v. Green Spring Health Servs., Inc.*, 280 F.3d 278, 287 (3d Cir. 2002)). We therefore turn to whether the associations’ preemption claim requires a sufficiently fact-intensive inquiry to preclude representational standing.

The FAAAA provides that a state law is preempted if it relates to the prices, routes, or services of "any motor carrier" or "an air carrier." 49 U.S.C. §§ 14501(c) & 41713(b)(4)(A) (emphases supplied). "Any" means "one... of whatever kind," and "an" means "one." *Merriam Webster’s Collegiate Dictionary* at 40, 53 (10th ed. 2001). The language of the FAAAA accordingly suggests that, if a state law is preempted as to one carrier, it is preempted as to all carriers. *See N.H. Motor Transp. Ass’n*, 377 F. Supp. 2d at 219. Such a reading accords with one of the FAAAA’s central purposes: to establish a "level playing field" among carriers. H.R. Conf. Rep. 103-677 at 85, *reprinted in* 1994 U.S.C.C.A.N. at 1757; *see Californians for Safe Dump Truck Transp. v. Mendonca*, 152 F.3d 1184, 1187 (9th Cir. 1998). If preemption were judged on a carrier-specific basis, the result would be a "patchwork" of state laws applying to some carriers and not to others, depending on which carriers proceeded to litigation. H.R. Conf. Rep. 103-677 at 87 *reprinted in* 1994 U.S.C.C.A.N. at 1759. Such a result would undermine Congress’ goal of encouraging uniformity in carrier regulation. Thus, the associations can prevail by establishing that the challenged provisions of the Tobacco Delivery Law have a forbidden significant effect on one carrier. The district court correctly ruled that the associations have standing to press their preemption claim. *See Rowe,* 429 F.3d at 314.

2. Mootness

After the district court granted summary judgment, UPS settled an enforcement action brought by the New York Attorney General under a New York law restricting the ability of carriers to deliver cigarettes to consumers. *See N.Y. Pub. Health Law § 1399 II(2) (McKinney 2001).* In that settlement, UPS promised to stop “shipping cigarettes to individual consumers in the United States while still permitting lawful shipments of cigarettes to licensed tobacco businesses.” To fulfill this promise, UPS agreed (1) to identify all shippers that may be cigarette retailers and advise them that UPS will not accept cigarettes for delivery to consumers; (2) to discipline shippers that violate UPS’s non-delivery policy; (3) to impose measures to ensure that employees “actively” look for indications that a package contains cigarettes; and (4) to instruct drivers not to deliver cigarette packages to consumers.

The Attorney General argues that, as a result of the settlement, this appeal has become moot, the judgment should be vacated and the case should be dismissed. *See Duke Power Co. v. Greenwood County*, 299 U.S. 259, 267, 57 S. Ct. 202, 81 L. Ed. 178.
(1936)(stating that where a case becomes moot while on appeal, the appellate court must set aside the judgment and remand the case with instructions that it be dismissed). He contends that, by agreeing not to deliver cigarettes directly to consumers throughout the United States and directing employees actively to look for cigarettes, UPS is no longer affected by the Tobacco Delivery Law.

Article III considerations require that an actual case or controversy exist between the parties throughout the course of litigation. See Ramirez v. Sanchez Ramos, 438 F.3d 92, 100 (1st Cir. 2006). A case must be dismissed as moot “if, at some time after the institution of the action, the parties no longer have a legally cognizable stake in the outcome.” Goodwin v. C.N.J., Inc., 436 F.3d 44, 46 (1st Cir. 2006). This rule applies even where the case becomes moot while pending on appeal. See Great Western Sugar Co. v. Nelson, 442 U.S. 92, 93, 99 S. Ct. 2149, 60 L. Ed. 2d 735 (1979)(per curiam). But “[t]he burden of establishing mootness rests squarely on the party raising it, and the burden is a heavy one.” Mangual v. Rotger-Sabat, 317 F.3d 45, 60 (1st Cir. 2003) (citation omitted). To establish mootness, the party raising it must show that the court cannot grant any “effectual relief whatever” to its opponent. Church of Scientology of Cal. v. United States, 506 U.S. 9, 12, 113 S. Ct. 447, 121 L. Ed. 2d 313 (1992).

The Attorney General has not met this heavy burden. The New York settlement agreement applies only to the delivery of cigarettes, but the Tobacco Delivery Law applies to “any form of tobacco and any material or device used in the smoking, chewing or other form of tobacco consumption.” 22 M.R.S.A. § 1551-3. UPS could therefore adhere to the terms of the settlement agreement and nevertheless violate the Tobacco Delivery Law by unlawfully delivering non-cigarette tobacco products. Because enjoining the challenged provisions would permit UPS to deliver all tobacco products, effectual relief remains available.

B. Preemption

We turn now to the merits of the district court’s preemption ruling. We review the ruling de novo, considering the record and all reasonable inferences in the light most favorable to the Attorney General. See Mullin v. Raytheon Co., 164 F.3d 696, 698 (1st Cir. 1999). We may affirm on any ground revealed by the record. See Houlton Citizens’ Coalition v. Houlton, 175 F.3d 178, 183-84 (1st Cir. 1999).

The Attorney General presents two arguments for reversal. First, he contends that the FAAAA does not preempt state laws enacted pursuant to a state’s police power to protect the health and welfare of its citizens. The Attorney General asserts that the FAAAA preempts only state laws that impose traditional economic regulation on carriers—e.g. entry and commodity controls, tariff filing requirements, and price ceilings. Because the Tobacco Delivery Law does not impose such traditional economic restrictions, the Attorney General argues that the FAAAA does not apply. Alternatively, the Attorney General contends that, even if the Act applies, neither challenged provision is “related to” carrier services within the meaning of the FAAAA.

1. Applicability of the FAAAA to a State’s Police-Power Enactments

A fundamental tenet of our federalist system is that constitutionally enacted federal law is supreme to state law. See U.S. Const. Art.

We begin with the text. As mentioned above, the FAAAA prohibits states from enacting laws “related to a price, route, or service” of a carrier. 49 U.S.C. §§ 14501(c) & 41713(b)(4)(A). This language was patterned after the preemption provision of the Airline Deregulation Act of 1978. See H.R. Conf. Rep. 103-677 at 85. reprinted in 1994 U.S.C.C.A.N. at 1755. The seminal case is Morales v. Trans World Airlines, Inc., 504 U.S. 374, 112 S. Ct. 2031, 119 L. Ed. 2d 157 (1992). Like the FAAAA, the version of the Airline Deregulation Act considered in Morales preempted state laws “relating to rates, routes or services of any air carrier.” The Court identified “relating to” as the key phrase in determining the breadth of the preemption provision and concluded that the “words . . . express a broad pre-emptive purpose.” Id. at 383. It relied on several cases in which the Court had interpreted a similarly-worded provision of the Employment Retirement Security Act of 1974 (ERISA) preempting all state laws that “relate to” an employee benefit plan. Id. at 384. The Morales Court emphasized that this language had an “expansive sweep” and that it was “conspicuous for its breadth.” Id. In light of Congress’ use of similarly broad language, the Court concluded that Congress intended the Airline Deregulation Act to preempt any state law that has “a connection with or reference to airline rates, routes, or services.” Id.

The FAAAA’s drafters were familiar with Morales and approved of its reasoning. The Conference Committee Report explains that “the conferees [did] not intend to alter the broad preemption interpretation adopted by the United States Supreme Court in Morales. . . .” H.R. Conf. Rep. 103-677 at 83. reprinted in 1994 U.S.C.C.A.N. at 1755. The sweep of the FAAAA’s text and the drafters’ expressed intent to use Morales as a roadmap are strong evidence that the FAAAA was not intended to preempt only a narrow class of economic regulations while excluding the many laws enacted by the states under their police powers. If Congress had such a limited purpose in mind, it likely

would have employed narrower language in fashioning the FAAAA preemption provisions. *Cf. Botz v. Omni Air Int'l.*, 286 F.3d 488, 493-94 (8th Cir. 2002) ("Although Congress could easily have selected more restrictive terminology to describe the type of . . . enactment the [Airline Deregulation Act] pre-empts, the provision as written is without language that would produce a more limited pre-emptive effect.").

The Attorney General argues that we should disregard *Morales* because, post-*Morales*, the Supreme Court has narrowed its understanding of ERISA’s "relat[ing] to" language. We previously rejected this identical argument:

The Secretary argues that the broad preemption standard adopted in *Morales* has been overruled by a number of Supreme Court cases narrowing the preemptive effect of [ERISA]. While the *Morales* Court undoubtedly took its interpretive cues from the ERISA preemption jurisprudence then in existence, it does not follow that any change in the ERISA law necessitates a parallel change in the law affecting . . . carriers. As Judge Easterbrook has put it: "[I]f developments in pension law have under-cut holdings in air-transportation law, it is for the Supreme Court itself to make the adjustments. Our marching orders are clear: follow decisions until the Supreme Court overrules them."

*UPS I*, 318 F.3d at 335 n.19 (quoting *United Airlines, Inc. v. Mesa Airlines, Inc.*, 219 F.3d 605, 608 (7th Cir. 2000)). Absent extraordinary circumstances not present here, we are not at liberty to disregard this ruling. See *United States v. Wogan*, 938 F.2d 1446, 1449 (1st Cir. 1991) ("We have held, time and again, that in a multi-panel circuit, prior panel decisions are binding upon newly constituted panels in the absence of supervening authority sufficient to warrant disregard of established precedent.").

We look also to the FAAAA’s structure and legislative history. The FAAAA includes a series of exceptions to the general preemption rule. The excepted areas are:

the safety regulatory authority of a State with respect to motor vehicles, the authority of a State to impose highway route controls or limitations based on the size or weight of the motor vehicle or the hazardous nature of the cargo, or the authority of a State to regulate motor carriers with regard to minimum amounts of financial responsibility relating to insurance requirements and self-insurance authorization.

49 U.S.C. §§ 14501(c)(2) & 41713(b)(4)(B)(i). The Attorney General acknowledges that the challenged provisions of the Tobacco Delivery Law do not fall within any of these exceptions. He contends, however, that these statutory exceptions suggest broader congressional purpose to permit states to regulate carriers to protect citizen health and safety. The Attorney General points to a passage from the FAAAA’s legislative history indicating that the enumerated exceptions were "not intended to be all inclusive," H.R. Conf. Rep. 103-677 at 84. *reprinted in 1994 U.S.C.C.A.N. at 1756*, to argue that we may
establish an additional exception to FAAAA preemption for laws enacted pursuant to a state’s police power to protect the health and welfare of its citizens.

We have cautioned that an overly broad interpretation of the FAAAA exceptions “would swallow the rule of preemption.” United Parcel Serv., Inc. v. Flores-Galarza, 385 F.3d 9, 14 (1st Cir. 2004)(UPS II). An exclusion from preemption for police-power enactments would surely “swallow the rule of preemption,” as most state laws are enacted pursuant to this authority. Id. The exceptions preserving the states’ authority to regulate motor vehicles do not support the Attorney General’s argument. See id. (rejecting an argument that the FAAAA preemption exceptions indicate a congressional intent to preserve state authority over safety issues generally).

While the statute’s structure does not support the Attorney General’s police-power argument, there is some support in the legislative history for his view that the FAAAA preempts only state economic regulation. The Conference Committee Report observed that “[s]tate economic regulation of motor carriers . . . is a huge problem for national and regional carriers attempting to conduct a standard way of doing business.” H.R. Conf. Rep. No. 103-677 at 85, reprinted in 1994 U.S.C.C.A.N. at 1757. The conferees identified “typical forms” of harmful regulation to include “entry controls, tariff filing, price regulation,” and regulation of the “types of commodities carried.” Id. at 1758. This history led the Supreme Court to remark that “the problem to which the [FAAAA] congressional conferees attended was state economic regulation.” Columbus v. Ours Garage & Wrecker Serv., 536 U.S. 424, 440, 122 S. Ct. 2226, 153 L. Ed. 2d 430 (2002). This history, however, does not indicate that preempting economic regulation was the FAAAA’s only purpose. And, in any event, the legislative history cannot trump the statute’s text. See Cipollone v. Liggett Group, Inc., 505 U.S. 504, 521, 112 S. Ct. 2608, 120 L. Ed. 2d 407 (1992)(declining to adopt a limited interpretation of a preemption provision suggested by legislative history because “the language of the [cigarette labeling] Act plainly reaches” further); Morales, 504 U.S. at 385 n.2 (The “legislative history need not confirm the details of changes in the law effected by statutory language before we will interpret that language according to its natural meaning.”). Congress often acts to address a specific problem but ultimately settles on a broader remedy. See Penn. Dep’t of Corr. v. Yeskey, 524 U.S. 206, 213. 118 S. Ct. 1952, 141 L. Ed. 2d 215 (1998)(“[T]he fact that a statute can be applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth.”).

In addition, the legislative history reveals a second goal for FAAAA preemption which is inconsistent with the Attorney’s General argument: “to create a completely level playing field between air carriers . . . on the one hand and motor carriers on the other.” H.R. Conf. Rep. 103-677 at 85, reprinted in 1994 U.S.C.C.A.N. at 1757. In other words, the conferees intended the scope of FAAAA and Airline Deregulation Act preemption to be coterminous. See Ace Auto Body & Towing Ltd. v. City of New York, 171 F.3d 765. 772 (2d Cir. 1999); Mendonca, 152 F.3d at 1187.

In the Airline Deregulation Act context, the Supreme Court has focused on the effect that a state law has on carrier operations, not
on the state's purpose for enacting the law. In *Morales*, the Court found that the Airline Deregulation Act preempted a directive promulgated by several state attorneys general informing airlines that certain advertising practices would be considered to violate state consumer-protection laws. 504 U.S. at 379. And, in *American Airlines, Inc. v. Wolens*, 513 U.S. 219, 227-28, 115 S. Ct. 817, 130 L. Ed. 2d 715 (1995), the Court held that the Airline Deregulation Act preempted a cause of action under the Illinois Consumer Fraud Act concerning the redemption of frequent-flier miles. In both cases, the Court’s preemption analysis centered on the impact that the challenged state laws had on airline services and rates and not on the fact that the preempted laws were enacted pursuant to the states’ police power to combat consumer fraud. See *Fla. Lime & Avocado Growers v. Paul*, 373 U.S. 132, 150, 83 S. Ct. 1210, 10 L. Ed. 2d 248 (1973)(describing the traditional state authority to pass laws to combat consumer fraud). The Court reached these conclusions over dissents by Justice Stevens arguing (similarly to the Attorney General here) that the state laws at issue should not be preempted because there was insufficient evidence of congressional intent to preempt state police-power enactments. See *Am. Airlines*, 513 U.S. at 235-31 (Steven, J. dissenting in part); *Morales*, 504 U.S. at 419-27 (Stevens, J., dissenting).

*Morales* and *American Airlines* thus teach that, under the Airline Deregulation Act, the focus should be on the effect that the state law has on airline operations. Accepting the Attorney General’s argument would shift the analysis under the FAAAA away from that state law’s effect and towards the state’s purpose for enacting the law. A purpose-related limitation on FAAAA preemption would thus inevitably create a gap between the scope of FAAAA and Airline Deregulation Act preemption—a gap which the FAAAA drafters sought to avoid.

In the end, the Attorney General’s argument founders because it cannot be reconciled with the FAAAA’s text. The Act’s drafters chose to express the preemptive scope of the FAAAA in words that they understood to be exceedingly broad. In the preemption context, we are to give effect to the ordinary meaning of a congressional enactment “unless there is good reason to believe that Congress intended the language to have some more restrictive meaning.” *Cipollone*, 505 U.S. at 521. We do not find a sufficiently compelling basis in either the structure or history of the FAAAA to interpret the Act contrary to its “deliberately expansive text.” *Morales*, 504 U.S. at 384. We therefore conclude that the FAAAA preempts state police-power enactments to the extent that they are “related to” a carrier’s prices, routes, or services.

2. FAAAA Preemption of the Tobacco Delivery Law

We turn now to whether the challenged provisions of the Tobacco Delivery Law are preempted because they are “related to” carrier services. The parties do not contest that carriers provide the service of delivering “packages on an express or time-guaranteed basis.” See *N.H. Motor Transp. Ass’n*, 377 F. Supp. 2d at 209 (quoting *UPS I*, 318 F.3d at 336). But they disagree over whether the challenged provisions are “related to” this service.

We have previously interpreted the phrase “related to” as used in the FAAAA:

The phrase “related to” has a broad meaning in ordinary usage:
to stand in some relation; to have bearing or concern; to pertain; refer; to bring in association or connection with. When used in a preemption provision, such as [in the FAAAA], it has a similarly broad reach. State laws and regulations having a connection with or reference to a . . . carrier’s . . . services are preempted under the [FAAAA]. A sufficient nexus exists if the law expressly references the . . . carriers’ . . . services or has a forbidden significant effect on the same.

UPS 1, 318 F.3d at 335. We therefore consider whether the district court correctly concluded that the challenged provisions of the Tobacco Delivery Law either expressly reference carrier services or have a forbidden significant effect on UPS’ services.

We begin with § 1555-C(3)(C). As set forth above, this statute requires tobacco retailers seeking to ship tobacco products directly to Maine consumers to use only carriers that deliver the package directly to the addressee/purchaser, require a signature from the addressee/purchaser, and conduct age verification if the addressee/purchaser is under 27 years of age. Another section penalizes retailers that use carriers that do not provide these services. 22 M.R.S.A. §§ 1555-C(3)(E)&(F).

Section 1555-C(3)(C) expressly references a carrier’s service of providing the timely delivery of packages. The statute prescribes the method by which a carrier operating in Maine must deliver packages containing tobacco products in a way that would affect the ability of the carrier to meet package-delivery deadlines. Delays in searching for the purchaser, making multiple delivery attempts if the purchaser cannot be located, obtaining the purchaser’s signature, and verifying the purchaser’s age all could affect timely deliveries. See UPS I, 318 F.3d at 336 (finding that the FAAAA preempted a state law that “affect[ed] the timeliness and effectiveness” of a carrier’s service).

The Attorney General responds that there is no FAAAA preemption because § 1555-C(3)(C) regulates retailers of tobacco products and not carriers. He also argues that we should decline to find preemption because any carrier can avoid the requirements of § 1555-C(3)(C) by declining to provide tobacco-product deliveries to Maine consumers.

The Attorney General’s first argument amounts to a claim that there can be no FAAAA preemption unless the state law imposes a direct regulation on carriers. This argument cannot be squared with the FAAAA’s text because it reads the broad phrase “related to” out of the statute and replaces it with the narrower term “regulates.” See Morales, 504 U.S. at 385 (rejecting an argument that would have read “relating to” out of the Airline Deregulation Act and replaced it with “regulate”); UPS I, 318 F.3d at 335 (rejecting an argument for narrowing scope of the FAAAA that “would read ‘the related to language’ out of the statute”).

Moreover, limiting preemption to direct regulation of carriers is inconsistent with the FAAAA’s purpose to bar states from policing carrier operations. See Am. Airlines, 513 U.S. at 228. A state may use its coercive power to cause carriers to conform to state-imposed rules in at least two ways: it may directly regulate carriers or it may limit retailers to hiring only those carriers that
comply with the state-imposed mandates. Either way the state is employing its coercive power to police the method by which carriers provide services in the state. In short, the Attorney General’s argument would lead to the untenable result of permitting states to regulate carrier services indirectly by regulating shippers. Cf. Abington Sch. Dist. v. Schemp, 374 U.S. 203, 230, 83 S. Ct. 1560, 10 L. Ed. 2d 844 (1963)(declining to adopt an interpretation that would permit states to do indirectly what they cannot do directly).

The Attorney General’s alternative argument—that there is no preemption because a carrier can forgo certain tobacco-product deliveries in Maine—also fails. Declining to find preemption simply because a carrier can limit its in-state business to avoid a particular requirement would undermine the FAAAA’s goal of creating an environment in which “[s]ervice options will be dictated by the marketplace,” and not by state regulatory regimes. H.R. Conf. Rep. 103-677 at 88, reprinted in 1994 U.S.C.C.A.N. at 1760. The district court correctly concluded that the FAAAA preempts § 1555-C(3)(C).

We turn finally to whether the FAAAA preempts § 1555-D. In considering this question, we are mindful that courts should “not nullify more of a legislature’s work than is necessary, for . . . a ruling of unconstitutionality frustrates the intent of the elected representative of the people.” Ayotte v. Planned Parenthood of N. New England, 126 S. Ct. 961, 967, 163 L. Ed. 2d 812 (2006)(internal citation omitted). The first part of § 1555-D makes it unlawful for any person knowingly to deliver to Maine consumers certain contraband tobacco products—i.e., those tobacco products purchased by consumers from unlicensed retailers. The second part of § 1555-D charges a carrier with knowledge that a package contains tobacco products if the package is so marked or if the shipper appears on the Attorney General’s list of unlicensed tobacco retailers.

Under Maine law, tobacco products purchased by a consumer from an unlicensed retailer are contraband. See 22 M.R.S.A. § 1555-C(7). The first part of § 1555-D is a corollary to § 1555-C(7) in that it makes the knowing delivery of contraband tobacco products illegal. Thus, the question we face is whether a generally applicable law barring any person from knowingly delivering contraband tobacco is preempted by the FAAAA insofar as the law pertains to carriers.

While the FAAAA’s preemptive effect is broad, see UPS I, 318 F.3d at 335, it is not unlimited, see Mendonca, 152 F.3d at 1188. State laws that only have a “tenuous, remote, or peripheral” relation to services are beyond the FAAAA’s reach. Morales, 504 U.S. at 390; Mendonca, 152 F.3d at 1188. In describing this limitation on preemption in the Airline Deregulation Act context, the Supreme Court explained that its broad interpretation of the statute’s preemption provision did not place it “on a road that leads to pre-emption of gambling and prostitution as applied to airlines.” Morales, 504 U.S. at 390. We understand the Morales Court to have meant that states may continue to enjoy the power to ban primary conduct. and that the ADA and FAAAA do not preempt laws applying these prohibitions to airlines and carriers.

Accordingly, Morales suggests that § 1555-D’s ban on the knowing delivery of contraband tobacco products is not preempted by the FAAAA—even only
insofar as it pertains to carrier services. Section 1555-D requires that carriers do not act as knowing accomplices in the illegal sale of tobacco products. It does not, however, require that carriers modify their delivery methods other than by declining to transport a product that Maine has legitimately banned. We think that this effect on services is "too tenuous" to warrant preemption. Mendonca, 152 F.3d at 1189 (stating that a state law is too tenuous to be preempted by the FAAAA where the law does not frustrate the FAAAA's deregulatory purposes).

If the rule were otherwise, states would be unable to bar a primary method by which contraband crosses state lines. We do not believe that this was Congress' intent in enacting the FAAAA. Other courts applying the FAAAA to prohibitions on the delivery of contraband tobacco have reached similar conclusions. See Robertson v. Liquor Control Bd., 102 Wn. App. 848, 10 P.3d 1079, 1084-85 (Wash. App. Ct. 2000) (concluding that the FAAAA did not preempt a state law banning the transport of contraband cigarettes because otherwise "a motor carrier would be exempt from forfeiture for transporting a methamphetamine lab or poached game"); see also N.Y. State Motor Truck Ass'n v. Pataki, 2004 U.S. Dist. LEXIS 25519, No. 03-CV-2386 (GBD), 2004 WL 2937803, at *6 (W.D.N.Y. Dec. 16, 2004) (concluding that the FAAAA did not preempt a state law making it unlawful for carriers to deliver cigarettes directly to New York consumers because "the mere fact that a statute concerns the transportation of a particular cargo by ... carriers ... does not render it ... unconstitutional on preemption grounds"); Ward v. New York, 291 F. Supp. 2d 188, 210-211 (S.D.N.Y. 2004) (similar).

But, while Maine may ban a carrier from knowingly transporting contraband tobacco products, it may not dictate the procedures that a carrier should employ to locate these products in its delivery chain. See UPS I, 318 F.3d at 336 (concluding that the FAAAA preempted a Puerto Rico revenue-collection scheme that mandated procedures that carriers had to follow to deliver certain packages). The second part of § 1555-D violates this principle.

As noted, § 1555-D imposes upon a carrier constructive knowledge that it has delivered a tobacco product if the package containing the product is marked as containing tobacco or if the seller's name appears on the Attorney General's list. As UPS' experience demonstrates, a carrier seeking to comply with § 1555-D must specially inspect every package destined for delivery in Maine. Once the carrier has finished this inspection, it must segregate the packages that contain tobacco and research whether the addressee is a Maine-licensed retailer or distributor who can receive the package. While the second part of § 1555-D does not expressly reference carrier services, it "impermissibly affect[s] ... services ... because it require[s] UPS to identify the contents of the packages (a deviation from standard procedures used in deliveries elsewhere in the United States). ..." UPS II, 385 F.2d at 14 (parenthesis in original). UPS can only provide timely package delivery if it follows uniform procedures that allow for "an orderly flow of packages." UPS I, 318 F.3d at 336. Because the second part of § 1555-D has the effect of forcing UPS to change its uniform package-processing procedures, the district court correctly found it to be preempted.

In reaching this conclusion, we recognize that there is a potential tension between saying that, on the one hand, Maine is free to punish the knowing delivery of material
that it has classified as contraband, while, on the other hand, ruling that it may not dictate or interfere with a carrier’s delivery procedures. What we are saying here, however, is that Maine cannot use the mechanisms outlined in the statute to *impute* knowledge based on a failure to read labels or consult lists—an imputation which would amount to prescribing how carriers must operate.

If, however, Maine could prove that a carrier employee had actual knowledge that a package being delivered was contraband tobacco, then it might have a colorable enforcement case—although such circumstances, as a practical matter, may be difficult to prove. True, the “related to” language could stretch to such a case but it could also stretch to the knowing delivery of hard drugs—and Congress cannot have intended such a result.

III.

“[T]obacco use, particularly among children and adolescents, poses perhaps the single most significant public health problem in the United States.” *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 161, 120 S. Ct. 1291, 146 L. Ed. 2d 121 (2000). There is no question that Maine has sought to achieve a worthy objective by passing the Tobacco Delivery Law to combat this pernicious problem. *See N.H. Motor Transp. Ass’n*, 377 F. Supp. 2d at 219. But the FAAA focuses on the effect that a state’s law has on carriers, and not on the state’s objective in passing the law. To the extent that Maine’s Tobacco Delivery Law requires (or has the effect of requiring) carriers to implement state-mandated procedures in the processing and delivery of packages, it is preempted by the FAAA. But to the extent that the Tobacco Delivery Law merely bars all persons (including carriers) from knowingly transporting contraband tobacco into Maine, the FAAA is not implicated.

We **AFFIRM** the judgment as it pertains to 22 M.R.S.A. § 1555-C(3)(C) and the second part of 22 M.R.S.A. § 1555-D but **REVERSE** the judgment as it pertains to the first part of § 1555-D. We **REMAND** the case to the district court with instructions to **AMEND** the judgment consistent with this opinion. No costs are awarded.

*So ordered.*
WASHINGTON—The Supreme Court on Monday agreed to consider reinstating Maine’s law aimed at regulating Internet sales of cigarettes to keep them out of the hands of minors.

Trade associations for delivery companies successfully argued in an appeals court that a federal statute supporting the free flow of interstate commerce pre-empted the Maine law.

The Maine attorney general, who asked the Supreme Court to hear the case, argues that states should be allowed to exercise their historic public health police powers to stop delivery of tobacco to children.

To comply with the state law, carriers must specially inspect every package containing tobacco and destined for delivery in Maine.

The 1st U.S. Circuit Court of Appeals found that carriers had to change their uniform package-processing procedures to comply with Maine’s law. That, said the appeals court, conflicts with the requirements of the Federal Aviation Administration Authorization Act. It says states may not enact a law related to a service of any shipper.

The 2003 state law makes it illegal to knowingly deliver tobacco products to a Maine consumer if the product was purchased from an unlicensed retailer. Retailers must use only commercial carriers who ensure that the buyer is at least 18.

The appeals court decision in the trade association’s favor “leaves delivery sales of tobacco to children unregulated by any government, a result nowhere suggested by Congress or supported by common sense,” the Maine attorney general’s office said in asking the Supreme Court to take the case.

The state law was prompted by an increase in Internet tobacco sales carried out by direct delivery to consumers through the mail or by commercial carriers. The phenomenon has complicated Maine’s efforts to regulate the sale of tobacco to minors and also caused it to lose tax revenue because of tax-free sales by unlicensed companies.

The Bush administration sided with the trade associations, urging the justices to reject the appeal.

The case is Rowe v. New Hampshire Motor Transport, 06-457.
The Maine Attorney General issued the following news release:

Today, the United States Supreme Court announced that it has agreed to review the case *Rowe v. New Hampshire Motor Transport*, 06-457 filed against the State of Maine by motor transport associations in Massachusetts, New Hampshire and Vermont. The associations challenged the 2003 Maine law that requires that internet tobacco retailers utilize carriers who take specific actions to ensure that packages containing tobacco products are not delivered to minors.

Attorney General Steve Rowe stated “We are pleased that the Supreme Court has agreed to hear this important case. States have the right and the duty to protect the health and safety of children. This state law does just that by preventing youth access to tobacco products.”

In the brief petitioning the Supreme Court to take the case, the Attorney General had criticized the lower court decision by stating that it “leaves delivery sales of tobacco to children unregulated by any government, a result nowhere suggested by Congress or supported by common sense.”

Rowe also noted: “The state law also levels the playing field between “bricks and mortar” retail stores in Maine and internet and mail order retailers when it comes to age verification.”

Attorney General Rowe said that his office will likely file the State’s brief in August and that the Supreme Court will likely hear the oral argument in the case in December.

**Background**

In 2003, the Maine Legislature found that internet and telephone sales of tobacco products had become a serious problem and that, by means of delivery services, enterprising retailers were seeking to avoid over-the-counter age verification requirements by selling the tobacco products to minors and delivering them not over-the-counter, but rather through third-party carriers such as UPS. In response to this dangerous practice, the Legislature enacted “An Act To Regulate the Delivery and Sales of Tobacco Products and To Prevent the Sale of Tobacco Products to Minors,” Me. Pub. L. 2003, c. 444.

One section of the Act requires retailers who ship tobacco products to use a delivery service that requires the purchaser to be the addressee, the addressee to be of legal age to purchase tobacco products and sign for the package, and, if the addressee is under 27 years old, to present a valid identification showing proof of age.

The Act also requires retailers who ship tobacco products to clearly indicate on the package that it contains tobacco products, and carriers must check packages to determine whether they bear such markings.

On October 10, 2003, three trade
associations whose members include such companies as UPS, Federal Express and DHL filed a lawsuit in the United States District Court for the District of Maine and claimed that the state Act is preempted by the Federal Aviation Administration Authorization Act of 1994.

On May 27, 2005, the District Court held that the state law was preempted by the federal law and ruled in favor of the trade associations. The Attorney General appealed to the United States Court of Appeals for the First Circuit. On May 19, 2006, the First Circuit issued its decision effectively affirming the lower court’s decision. The Attorney General then filed a petition asking the United States Supreme Court to review the matter.
On Friday the SG’s office filed this brief recommending that the Court deny cert. in No. 06-457, Rowe v. New Hampshire Motor Transport Association. The SG’s brief in Rowe is also, in all likelihood, the last invitation brief that will be filed this Term; although we had previously indicated that we expected a brief in No. 06-415, Selig v. Pediatric Specialty Care, last Friday was—as we understand it—the last day for the SG to file a brief and (if the normal timelines are followed . . .) still have the case considered before the Court’s summer recess, and the Court’s electronic docket does not indicate that any such brief was filed.

If (as we now expect) the brief in Rowe is indeed the last SG brief for the Term, the final score is six recommended denials and just one recommended grant (in No. 06-856, LaRue v. DeWolff, Boberg & Associates . . . ). Although the Court normally accords substantial weight to the SG’s recommendations—and it would thus seem likely that this group of CVSG cases would not be a significant source of new cases for the Court’s OT2007 docket—the Court’s need for cases could change the calculus considerably.

At issue in Rowe is whether the Federal Aviation Administration Authorization Act (FAAAA, not to be confused with the FAA (Federal Arbitration Act), which features prominently in Hall Street Associates v. Mattel, Inc., in which cert. was granted yesterday) preempts provisions of a Maine law that would require shippers which deliver tobacco products to, among other things, obtain the signature of the purchaser and, if he or she is under the age of twenty-seven, verify the purchaser’s age. The SG’s recommendation that cert. be denied rests primarily on its belief that the decision below was correctly decided; the provisions at issue impose precisely the kind of “burdens . . . on interstate commerce and the free flow of traffic” that Congress intended to eliminate with the FAAA’s preemption provisions. And although the government hastens to emphasize that it “shares the State’s interest in combating youth tobacco use,” it explains that other means are available—including under the current Maine law—to do so. Finally, it disputes petitioner’s suggestion that the First Circuit’s decision conflicts with the holdings of other courts.