07-5687-cv

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

JOE IBARZABAL, JENS CHRISTIAN SORENSEN, BILLY F. ADAMS, JUDY ADAMS, MACK D. YOAKUM, L. VERMELL YOAKUM, PATSY D. DEVEAU and ESTATE OF CHARLES DEVEAU, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

v.

MORGAN STANLEY DW, INC.,

Defendant-Appellee.

On Appeal from the United States District Court
for the Southern District of New York (White Plains)

BRIEF FOR PLAINTIFFS-APPELLANTS

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PRELIMINARY STATEMENT

For the reasons and authorities set forth below, plaintiffs/appellants Joe Ibarzabal, Jens Christian Sorensen, Billy F. Adams, Judy Adams, Mack D. Yoakum, L. Vermell Yoakum, Patsy D. DeVeau, and Estate of Charles DeVeau (hereinafter "plaintiffs") respectfully request that this Court reverse the district court's dismissal of their complaint and denial of leave to file an amended complaint.

STATEMENT OF SUBJECT MATTER AND APPELLATE JURISDICTION

A. Plaintiffs brought claims pursuant to the common law and New York General Business Law 349. The basis for jurisdiction in the district court was 28 U.S.C. § 1332(d). Members of the class in this putative class action are and were citizens of different states than defendant Morgan Stanley DW, Inc. ("defendant" or "Morgan Stanley"), and the aggregate amount in controversy exceeds $5 million, exclusive of interest and costs.

B. Upon granting defendant's motion to dismiss, the district court entered final judgement dismissing the case on December 10, 2007. (Joint Appendix (hereinafter "JA") A198) Appellants timely filed their Notice of Appeal on December 18, 2007. (JA A199) Thus, this Court has jurisdiction pursuant to 28 U.S.C. §§ 1291 and 1294.

STATEMENT OF THE ISSUES PRESENTED FOR REVIEW

A. Whether the district court erred in dismissing the complaint based on the Federal Arbitration Act, 9 U.S.C. § 10 *et seq.*, where the class action claims asserted in the complaint did not seek an order vacating any arbitration award(s), were not the subject of an agreement requiring them to be arbitrated and were not arbitrable under the rules of the National Association of Securities Dealers ("NASD") and/or the New York Stock Exchange ("NYSE").

B. Whether the district court erred in dismissing the complaint where the alleged conduct of defendant in concealing and destroying evidence relevant to arbitration proceedings (and systematically deceiving litigants and regulators concerning the purported destruction of Morgan Stanley's e-mail system in the collapse of the World Trade Center) constituted a tort and statutory violation independent of the violation of any NASD and/or NYSE arbitration rules proscribing concealment and destruction of evidence. See Mian v. Donaldson, Lufkin & Jenrette Sec. Corp., 7 F. 3d 1085 (2d Cir. 1993).

C. Whether the district court erred in dismissing the complaint against plaintiffs whose arbitration cases were not the subject of any final award that would potentially be subject to the provisions for vacatur of arbitration awards set forth in the Federal Arbitration Act, 9 U.S.C. § 10(a)(1).

D. Whether the district court erred in dismissing the claims of putative class plaintiffs who signed releases, where plaintiffs alleged fraud in the inducement and defendant's fraudulent course of conduct in destroying and concealing evidence had not been revealed at the time plaintiffs executed their releases.

E. Whether the district court erred in denying leave to amend the complaint.

STATEMENT OF THE CASE

A. Nature of the Case

This is a putative class action under Fed. R. Civ. P. 23(a), (b)(2) and (b)(3) on behalf of all persons who a) were claimants in NASD or NYSE arbitration proceedings against Morgan Stanley on or after October 1, 2001; and, b) were told by Morgan Stanley and/or its counsel in connection with such proceedings that Morgan Stanley's e-mails from prior to October, 2001 had been destroyed in the collapse of the World Trade Center (the "Class").

This putative class action asserts claims for breach of contract, common law fraud, and violation of New York GBL § 349 and seeks relief including an injunction forbidding Morgan Stanley from continuing its unlawful practices, statutory and compensatory damages, disgorgement of unjust enrichment, restitution, punitive damages and an award of attorneys' fees.

Specifically, the action seeks redress for Morgan Stanley's egregious course of conduct in attempting to take advantage of 9/11 by falsely claiming that it did not have any e-mails created prior to October 2001 during the period October 2001 through at least late 2006, when in fact Morgan Stanley knew *as of October 2001* that it had a near-complete backup copy of its pre-October 2001 e-mails, and deliberately set about to conceal the existence of this data.

B. Proceedings in the District Court

Plaintiffs Joe Ibarzabal and Jens Christian Sorenson filed a class action complaint on March 16, 2007. (JA A8) Plaintiffs subsequently filed an Amended Class Action Complaint on May 14, 2007, which was substantially identical to the initial complaint except that it added plaintiffs Billy F. Adams, Judy Adams, Mack D. Yoakum, L. Vermell Yoakum, Patsy D. DeVeau, and Estate of Charles DeVeau. (JA A25)

Morgan Stanley moved to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) on May 15, 2007. (JA A44) Oral argument on the motion was held on July 31, 2007. The district court granted the motion by decision and order dated December 3, 2007. (JA A188) The district court clerk entered judgment on December 10, 2007 (JA A198) and plaintiffs timely noticed the instant appeal (JA A199).

STATEMENT OF FACTS

A. The Morgan Stanley E-Mail System

When e-mails were created and sent on Morgan Stanley's e-mail system, they existed and were saved as data files on e-mail servers. (JA A31) These files could be viewed by both senders and recipients of e-mail on the Morgan Stanley system but were saved on Morgan Stanley's servers, not each user's individual computer. (JA A31) When a user moved a sent or received e-mail into a folder on his individual computer, however, it was effectively deleted from the central Morgan Stanley server system (but was preserved in the memory of the individual user's computer unless and until it was deleted). (JA A31)

At relevant times, Morgan Stanley's servers were backed up on a daily basis, resulting in the creation of a copy of the content of the servers on back-up disaster recovery tapes, to be used for restoration of the e-mail system in case of its destruction or loss. (JA A32)

B. The Destruction of Some Copies of Morgan Stanley's E-mail Files in the Collapse of the World Trade Center

All of Morgan Stanley's e-mail servers, including its archive servers and archive tapes, were destroyed on September 11, 2001. (JA A32) E-mails that users had moved into personal folders on individual computers for all employees located outside of the World Trade Center were not affected. (JA A32)

However, a near-complete backup tape created in the ordinary course of business on August 30, 2001 existed in an off-site location. (JA A32) Thus, other than the files for the Morgan Stanley e-mails created between August 31, 2001 and September 11, the servers containing the data were destroyed but *most of the data continued to exist in a backup copy in another location*. (JA A32)

C. Morgan Stanley Restores Most of Its E-mail Data Almost Immediately After 9/11 Utilizing Back-Up Tapes

Morgan Stanley was able to rebuild its e-mail system in a new location by September 17, 2001, by using the back-up disaster tapes that had been created in the normal course of business after the close of business on August 30, 2001 (which were the most recently-created back-up tapes still in existence). (JA A32) By using these tapes, Morgan Stanley was able to restore the data that had been stored on 11 of its 12 e-mail servers. (JA A32) These tapes contained millions of e-mails. (JA A32) Due to technology problems Morgan Stanley was unable to reload the data from the 12th server's back-up tapes until 2006. (JA A32)

When Morgan Stanley's e-mail system was restored on September 17, 2001, the system contained the e-mails that had been on the system as of the close of business on August 30, 2001, with the exception of those on the 12th server. (JA A32-33) Morgan Stanley restored to its system millions of pre-October 2001 e-mails. (JA A33) When Morgan Stanley employees logged onto

the firm's e-mail system on or after September 17, 2001, their mailboxes, including their lnboxes and Sent Items folders, contained whatever e-mails had been there as of the close of business on August 30, 2001, with the exception of those on the 12th server. (JA A33) All users of Morgan Stanley's e-mail system (including, presumably, in-house legal counsel) were thus able to see those e-mails on their computers as of September 17, 2001. (JA A33)

D. Even Though It Had A Near-Complete Backup Copy, Morgan Stanley Told Litigants and Regulators for Five Years that its E-mail Data Was Destroyed on September 11, 2001.

Despite the fact that it had a near-complete backup of the pre-October 2001 e-mails, Morgan Stanley routinely told claimants in arbitration proceedings and regulators that its pre-September 11, 2001 e-mails were destroyed in the collapse of the World Trade Center. (JA A33) It made a uniform misrepresentation to many litigants and arbitration claimants as follows:

> Morgan Stanley's email archive system was destroyed in the attacks on the World Trade Center on September 11, 2001. A replacement archive system was put into operation on or about October 9, 2001. That archive system has captured external email sent or received from that date forward and was later enhanced to capture internal email sent or received on or after June 7, 2002... .

(JA A123-124)

This statement (and variants thereof), which was still being made as of late 2006, was knowingly false and misleading because,

in fact, Morgan Stanley had a nearly complete backup of all of its e-mails available as early as **September 17, 2001.** (JA A32) As Morgan Stanley well knew, its e-mails had been recovered from back-up tapes almost immediately after September 11, and had been restored to the firm's e-mail servers and were available to respond to requests for e-mail. (JA A32-33)

Instead of searching for and making a production of relevant e-mails in the numerous arbitrations and litigations that it faced as a result of the adverse stock market conditions that prevailed during 2001-03, Morgan Stanley routinely made the representation in its discovery responses that Morgan Stanley's e-mail archive system was destroyed in the attacks on the World Trade Center on September 11, 2001. (JA A34) As a result of this course of conduct, documents subject to discovery requests in numerous customer arbitration proceedings were not provided to claimants, i.e., members of the putative class herein. (JA A34)

Morgan Stanley also failed to provide pre-October, 2001 e-mail to NASD when NASD requested and falsely represented to NASD that the firm had no such e-mails. (JA A34) This wrongdoing has resulted in the commencement of the proceeding styled Department of Enforcement v. Morgan Stanley DW, Inc., NASD Disciplinary Proceeding No. 2005001449202, which Morgan Stanley ultimately settled for $12.5 million. (JA A34) Morgan Stanley also paid $15 million in fines to settle an SEC case alleging

that Morgan Stanley failed to produce tens of thousands of e-mails requested by the SEC and "made numerous misrepresentations concerning the status and completion of its productions; the unavailability of certain documents; and its efforts to preserve requested e-mail." SEC Litigation Release No. 19693 (May 10, 2006). (JA A130)

In response to Information Memo No. 01-34, which required member firms to indicate which records they had lost in the collapse of the World Trade Center, by letter dated November 28, 2001 Morgan Stanley told the New York Stock Exchange that it "lost e-mails sent to or from the World Trade Center complex... ." (JA A35) On May 1, 2002, Morgan Stanley supplemented this response in another letter, stating that "our Communications Group informed me that storage of our E-mail records were also lost." (JA A35) In September 2002, Morgan Stanley partially corrected this statement by informing the NYSE that some e-mails existed on individual users' hard drives, but failed to disclose that many more pre-September 11, 2001 e-mails existed on the firm's servers or that pre-September 11, 2001 e-mails existed on back-up tapes which were constantly being erased and reused to store more recently created e-mails. (JA A35)

In response to a subpoena issued by the Massachusetts Securities Division on September 5, 2003 calling for the

production of e-mails sent to or received by five specified individuals from June 2000 through the date of the subpoena, Morgan Stanley produced external e-mails from after October 9, 2001 and, through counsel, represented that earlier e-mails were destroyed on September 11, 2001. (JA A35)

Even as it lied to litigants, regulators, arbitration panels, and the courts concerning its e-mail records, Morgan Stanley also deleted, caused to be deleted, and permitted users on Morgan Stanley's e-mail system to delete, e-mails that were potentially responsive to legitimate discovery requests in NASD and NYSE arbitrations. (JA A36)

Morgan Stanley well knew that e-mails were routinely subject to production to claimants in NASD and NYSE arbitration proceedings. (JA A36) In fact, such e-mail communications are (and were at relevant times) presumptively discoverable under the NASD Discovery Guide, which is contained in NASD Notice to Members 99-90. (JA A36) Thus, Morgan Stanley's unlawful course of conduct was calculated to (and did) frustrate Class members' attempts to obtain information to which they were lawfully entitled. (JA A36)

Of note, although Morgan Stanley sent a letter advising arbitration claimants in April 2005 of the *possibility* that it might have some additional sources of e-mail data to search (see JA A48, A87, A96, A109), the true scope of Morgan Stanley's

concealment of its e-mail records did not become known until December 19, 2006, when the National Association of Securities Dealers initiated proceedings against Morgan Stanley alleging the same facts underlying this case. See news release announcing the filing of NASD case, found at JA A132, A162. Shortly thereafter, plaintiffs (whose arbitration cases were already closed) commenced this class action.

When Morgan Stanley finally agreed to settle the NASD proceeding[1], it consented to the following findings by NASD:

a. Morgan Stanley destroyed millions of pre-September 2001 e-mails that were preserved on its backup tapes after the collapse of the World Trade Center by permitting the backup tapes to be overwritten with other data;

b. Morgan Stanley did not provide pre-October 2001 e-mail in numerous customer arbitration proceedings and in response to regulatory inquiries, stating falsely that it did not have any pre-October 2001 e-mails; and

c. Morgan Stanley's conduct violated NASD rules including NASD Procedural Rule 8210, NASD Conduct Rules 2110 and 3110, as well as NASD Code of Arbitration Procedure Rules 2110 and IM-10100.

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[1]The settlement agreement between NASD and Morgan Stanley is embodied in FINRA Letter of Acceptance, Waiver and Consent No. 2005001449202 ("AWC") http://www.finra.org/web/groups/enforcement/documents/enforcement/p037039.pdf

(AWC, pp. 5-6).

The AWC also specifically contains the finding that Morgan Stanley violated Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-4 promulgated thereunder (setting forth record-keeping requirements for broker-dealers). (AWC, p. 8).

Of note, the AWC also contains the finding that Morgan Stanley destroyed **at least** *7.8 million e-mails, over a period of more than three years between October 9, 2001 and March 2005.*

SUMMARY OF THE ARGUMENT

The district court erred in applying the Federal Arbitration Act to bar plaintiffs' claims because this class action does not seek to vacate an arbitration award. Therefore, the general rule that Section 10 of the Federal Arbitration Act is usually an arbitration claimant's exclusive remedy to challenge an arbitration award is inapplicable herein.

Further, this class action case is not eligible for arbitration under New York Stock Exchange ("NYSE") or National Association of Securities Dealers ("NASD") rules. As such, the FAA is simply inapplicable herein, and the district court erred by effectively enforcing an arbitration agreement against plaintiffs even though plaintiffs' claims are not even eligible to be arbitrated. See Nielsen v. Piper, Jaffray & Hopwood, 66 F.3d 145, 148-49 (7th Cir. 1995).

The FAA is inapplicable for the additional reason that the claims herein are not required to be arbitrated under Morgan Stanley's standard form of customer agreement. In summary, plaintiffs have previously brought arbitrable individual claims in arbitration, found out about Morgan Stanley's fraud in December 2006 after their arbitration claims were closed, and now bring separate, non-arbitrable class action claims in court. The FAA is simply not applicable in these circumstances. See Sole Resort, S.A. de C.V. v. Allure Resorts Management, LLC, 450 F.3d 100, 104 (2d Cir. 2006) (arbitration is entirely a creature of contract).

The district court also erred in failing to apply this Court's decision in Mian v. Donaldson, Lufkin & Jenrette Securities Corp., 7 F.3d 1085 (2d Cir. 1993) to permit plaintiffs to assert claims for a statutory violation notwithstanding the fact that the statutory violation happened to occur during the course of an arbitration proceeding.

Finally, the district court erred in effectively granting Morgan Stanley summary judgment on its affirmative defense of release (as against the plaintiffs who settled their cases prior to the revelation of Morgan Stanley's fraud), as this is not a circumstance in which "the complaint itself establish[es] the circumstances required as a predicate to a finding" that the affirmative defense applies. McKenna v. Wright, 386 F.3d 432,

435 (2d Cir. 2004). To the extent that the district court believed that the affirmative defense of release might be applicable, it erred by refusing to grant plaintiffs leave to amend to further explain their claim that they were fraudulently induced into settling their cases in the absence of material information concerning Morgan Stanley's fraud and destruction of evidence.

STANDARDS OF REVIEW

This Court reviews the district court's dismissal of plaintiffs' complaint de novo. See Peay v. Ajello, 470 F.3d 65, 67 (2d Cir. 2006).

This Court reviews the district court's denial of leave to amend a complaint for abuse of discretion. Gurary v. Winehouse, 235 F.3d 792, 801 (2d Cir. 2000).

ARGUMENT

I. THE DISTRICT COURT ERRED IN DISMISSING PLAINTIFFS' CLAIMS UNDER THE FAA, BECAUSE PLAINTIFFS' CLAIMS ARE NOT A COLLATERAL CHALLENGE TO AN ARBITRATION AWARD AND, INDEED, COULD NOT HAVE BEEN ASSERTED IN ARBITRATION

This class action arises out of a shockingly cynical decision by Morgan Stanley to use the events of September 11, 2001 as a pretext for refusing to honor its discovery obligations in the numerous litigations and arbitrations filed against it after the end-of-millenium bubble in stock prices and technology stocks burst. Morgan Stanley apparently decided that 9/11

provided a conveniently well-timed pretext for claiming that it had no pre-September 11, 2001 e-mails, just as litigation claims (as well as regulatory actions) against it multiplied alleging false analyst reports, manipulation of aftermarket prices of initial public offerings, and improper mutual fund sales practices, among other things.

Plaintiffs are arbitration claimants who are justifiably outraged by what can only have been a deliberate decision to withhold e-mail from them and other class members, on the theory that any eventual fines or penalties arising out of its conduct (if Morgan Stanley's conduct was even discovered) would add up to less than the incremental cost of litigating and settling arbitration claims and class actions brought by litigants armed with incriminating Morgan Stanley e-mails.

Thus, plaintiffs seek not a "do over" of their arbitration cases or orders vacating arbitration awards, but rather damages (including statutory damages under New York GBL 349 that do not require proof of economic loss) to compensate plaintiffs and the class and punish Morgan Stanley for its wrongdoing.

A. The FAA is inapplicable because this case does not seek to vacate any arbitration award(s).

The district court's dismissal of the claims of claimants whose arbitration cases terminated with awards (rather than settlements) rests on its conclusion that Section 10 of the Federal Arbitration Act ("FAA"), 9 U.S.C. § 10, provides the

exclusive remedy for challenging an arbitration award. But, crucially, plaintiffs have never asked for a vacatur of their arbitration awards nor a "do over" of their arbitration awards. Rather, the remedies sought herein include *only* an injunction, statutory and compensatory damages, disgorgement of unjust enrichment, restitution, punitive damages, attorneys' fees and costs, and "such other legal or equitable relief, including costs and attorneys' fees, as the Court deems just and equitable." See Amended Complaint at Prayer for Relief, JA A42.

Thus, the district court has effectively rewritten the complaint in order to fit its rationale that "the injuries alleged by Plaintiffs are predicated on the impact of MSDW's alleged conduct on the outcomes of their arbitration proceedings; accordingly, this Court must view the instant action as an attempt by those Plaintiffs who actually received final arbitration awards to collaterally attack those awards." (JA A192-193)

This was error, as it is the allegations of the complaint that should govern on a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6), not defendant's characterization or self-serving recasting of those allegations. "Defendants have rewritten the Complaint[] in a way that they believe favors dismissal. It must be remembered, however, that plaintiffs are the master of their complaint and 'neither this Court nor the

defendant have the right to redraft the complaint...' [internal citation omitted]. Defendants must take the Complaints as they are written." In re Initial Public Offering Secs. Litig., 241 F. Supp. 2d 281, 332-33 (S.D.N.Y. 2003).

The plain language of the FAA does not sweep up a claim such as that in the case at bar. Section 10(a) of the FAA provides as follows:

> (a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—
>
> > (1) where the award was procured by corruption, fraud, or undue means;
> >
> > (2) where there was evident partiality or corruption in the arbitrators, or either of them;
> >
> > (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or
> >
> > (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

Courts have subsequently held that this procedure is normally the exclusive remedy for challenging an arbitration award. See Corey v. New York Stock Exchange, 691 F.2d 1205, 1212

(6th Cir. 1982)[2]. But where, as here, plaintiffs do not seek to vacate any arbitration awards, and seek statutory damages that do not require them to to prove that they "would" have won their arbitration cases absent wrongdoing by Morgan Stanley, such a rationale makes no sense.

Here, plaintiffs can obtain a substantial classwide recovery without proving that they "would" have won (or continued prosecuting) their arbitration claims absent Morgan Stanley's misconduct. A prima facie case under GBL § 349 (one of the three causes of action asserted by plaintiffs) requires only a showing that a defendant is engaging in an act or practice that is deceptive or misleading in a material way. See, e.g., Oswego Laborers' Local 214 Pension Fund v. Marine Midland Bank, 85 N.Y.2d 20, 25 (1995). The New York Court of Appeals has adopted an objective definition of deceptive acts and practices, holding that the misrepresentations or omissions actionable under GBL § 349 are limited to those likely to mislead a reasonable consumer acting reasonably under the circumstances. Id. at 26. In the case of omissions, where as here the defendant alone possesses material information and fails to provide this information to the consumer, the omission is actionable. Id.

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[2]This Court's discussion of Corey in Mian v. Donaldson, Lufkin & Jenrette Securities Corp., 7 F.3d 1085 (2d Cir. 1993) is discussed at Point II, infra.

A plaintiff is not required to allege injury under GBL § 349 with great specificity. See Meyerson v. Prime Realty Services, LLC, 7 Misc.3d 911, 796 N.Y.S.2d 848, 856 (Sup. Ct. N.Y., Feb. 28, 2005). Although an actual injury is required by GBL § 349, it need not involve a pecuniary loss. Oswego, 85 N.Y.2d at *26. "[A] clear distinction exists between the deception *being the injury* and a real right being lost." Anonymous v. CVS Corp., 188 Misc.2d 616, 625 (N.Y. Sup. Ct. Mar. 1, 2001), *grant of class certification affirmed* 293 A.D.2d 285 (1st Dept. 2002) [emphasis supplied] (plaintiff's claim that defendant deprived him of the right to take action to prevent disclosure of his private medical information sufficient to allege actual injury under GBL § 349); Meyerson, 796 N.Y.S.2d at 856("[I]t cannot be doubted that a privacy invasion claim and an accompanying request for attorney's fees may be stated under GBL § 349 based on non-pecuniary injury... .")[3].

Here, plaintiffs have pleaded that they were deprived of material information, and were also injured due to defendant's deceptive business practice of destroying evidence. See Amended Complaint at ¶¶ 30-32 (JA A35-36). GBL § 349 claims are subject to the pleading standard set forth in Fed. R. Civ. P. 8(a).

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[3]See also Remsburg v. Docusearch, Inc., 149 N.H. 148, 816 A.2d 101 (2003)(similar result under New Hampshire law); Bio-Vita, Ltd. v. Rausch, 759 F.Supp. 33 (D. Mass. 1991)(under Massachusetts law).

Pelman v. McDonald's Corp., 396 F.3d 508, 512 (2d Cir. 2005). Plaintiffs have pleaded that they were injured by Morgan Stanley's conduct, and need not seek a vacatur of their arbitration awards nor prove that they "would" have won their arbitration awards to recovery. Quite simply, Section 10 of the FAA is not applicable in this case because this case is neither an actual nor a de facto application for an "order vacating the award upon the application of any party to the arbitration... ." See FAA § 10(a).

B. The FAA is inapplicable because this class action is not (and never was) an arbitrable claim under NASD and NYSE rules.

NASD Code of Arbitration Procedure § 10301(d) (hereinafter referred to as "Rule 10301") provided in its entirety at relevant times as follows[4]:

(d) Class Action Claims

(1) A claim submitted as a class action shall not be eligible for arbitration under this Code at the Association.

[4]NAT'L ASS'N OF SEC. DEALERS, NASD MANUAL § 10301 (Amended June 11, 2002); see also Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, Exchange Act Release No. 34-31371, 57 Fed. Reg. 52659 (Nov. 4, 1992). This provision was in effect at all times relevant to this class action. The rule was amended as of April 17, 2007 but continues to prohibit class actions in arbitration. See Exchange Act Release No. 34-51856, 70 Fed. Reg. 36442 (June 23, 2005).

(2) Any claim filed by a member or members of a putative or certified class action is also ineligible for arbitration at the Association if the claim is encompassed by a putative or certified class action filed in federal or state court, or is ordered by a court to an arbitral forum not sponsored by a self-regulatory organization for classwide arbitration. However, such claims shall be eligible for arbitration in accordance with paragraph (a) or pursuant to the parties' contractual agreement, if any, if a claimant demonstrates that it has elected not to participate in the putative or certified class action or, if applicable, has complied with any conditions for withdrawing from the class prescribed by the court. Disputes concerning whether a particular claim is encompassed by a putative or certified class action shall be referred by the Director of Arbitration to a panel of arbitrators in accordance with Rule 10302 or Rule 10308, as applicable. Either party may elect instead to petition the court with jurisdiction over the putative or certified class action to resolve such disputes. Any such petition to the court must be filed within ten business days of receipt of notice that the Director of Arbitration is referring the dispute to a panel of arbitrators.

(3) No member or associated person shall seek to enforce any agreement to arbitrate against a customer, other member or person associated with a member who has initiated in court a putative class action or is a member of a putative or certified class with respect to any claims encompassed by the class action unless and until: (A) the class certification is denied; (B) the class is decertified; C) the customer, other member or person associated with a member is excluded from the class by the court; or (D) the customer, other member or person associated with a member elects not to participate in the putative or certified class action or, if applicable, has complied with any conditions for withdrawing from the class prescribed by the court.

(4) No member or associated person shall be deemed to have waived any of its rights under this Code or

> under any agreement to arbitrate to which it is party except to the extent stated in this paragraph.

The NASD adopted this rule change in 1992 at the suggestion and insistence of then-SEC Chairman David S. Ruder, who believed that the courts had developed a specialized expertise in adjudicating class action claims and that developing a parallel system of class action arbitration at the NYSE and NASD would be "difficult, duplicative and wasteful." See SEC Release No. 34-31371 (October 28, 1992), 57 Fed. Reg. at 52661; see also Note: Difficult, Duplicative and Wasteful?: The NASD's Prohibition of Class Action Arbitration in the Post-*Bazzle* Era, 28 Cardozo L. Rev. 1891, 1892 n. 8 (hereinafter referred to as the "Cardozo Article").

This rule change came shortly after the U.S. Supreme Court, in a series of decisions between 1985 and 1987, effectively made SRO arbitration mandatory for all securities industry customers by ruling that mandatory arbitration provisions contained in customer account agreements are enforceable under the Federal Arbitration Act. See Dean Witter Reynolds v. Byrd, 470 U.S. 213, 105 S.Ct. 1238, 84 L.Ed.2d 158 (1985); Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 107 S. Ct. 2332, 2337, 96 L. Ed. 2d 185 (1987). Since the securities industry almost universally includes such mandatory arbitration clauses in its agreements with customers in the United States and the agreements are enforceable, as a practical matter SRO arbitration is the only

dispute resolution mechanism available for public customers of brokerage houses in the United States. See Cardozo Article at 1905.

Prior to the adoption of Rule 10301, brokerage houses had opportunistically seized upon the rulings in Byrd and McMahon and used arbitration clauses to eviscerate customer class actions by moving to compel arbitration against the individual named plaintiffs. See Cardozo Article at 1911, n. 147. The strategy was simple - defense attorneys would pick off each named plaintiff by compelling arbitration, thereby effectively preventing public customers from obtaining redress for legal claims against brokerage houses on a class-wide basis[5].

Rule 10301 can be seen as a deliberate regulatory reaction to this unfair litigation landscape, as it eliminated the defendants' strategic "trump card" for dealing with class actions via motions to compel arbitration against the individual plaintiffs. Rule 10301 simply carved class action claims out of the category of claims subject to SRO arbitration, permitting customers to proceed as a class.

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[5]Until the U.S. Supreme Court's decision in Green Tree Financial Corp. v. Bazzle, there was considerable doubt as to whether claims could be asserted on a class-wide basis in arbitration proceedings. See 539 U.S. 444, 452, 123 S.Ct. 2402, 156 L.Ed.2d 414 (2003). Thus, prior to Bazzle, an order compelling arbitration was likely to have the practical effect of preventing a plaintiff from seeking relief on behalf of a class and limiting the plaintiff to his or her individual remedies.

The courts have uniformly enforced the unambiguous language of Rule 10301[6] permitting class actions, and have repeatedly recognized that class action claims are not subject to SRO arbitration and may proceed in court. See, e.g., Nielsen v. Piper, Jaffray & Hopwood, 66 F.3d 145, 148-49 (7th Cir. 1995) (stating that "the extent of the 'law' of arbitration was cut back by the SEC when it pronounced that claims which had previously been filed as a class action or were encompassed by a class action were now ineligible for arbitration"); Coheleach v. Bear, Stearns & Co., Inc., 440 F. Supp. 2d 338, 341 (S.D.N.Y. 2006) (because of Rule 10301, class action claims could be pursued in court notwithstanding employment agreement that purported to require employee of brokerage firm to arbitrate all claims); Miron v. BDO Seidman, LLP, 342 F. Supp. 2d 324, 331-32 (E.D. Pa. 2004) (notwithstanding valid arbitration clause in customer agreement, under Rule 10301 members of class in class action who filed individual lawsuit in federal court could not be compelled to arbitrate their claims against NASD member firm during the pendency of class action); Olde Discount Corp. v. Hubbard, 172 F.3d 879 (Table), 1999 WL 79389 (10th Cir. Feb. 19, 1999) (affirming district court's ruling that

[6]The courts have reached the same conclusions with respect to the substantively identical NYSE Arbitration Rule 600(d). See, e.g., Pecan East Antonio Investors, Inc. v. KPMG LLP, No. Civ. A. SA 04-CA-0677FB, 2005 WL 2105751 at *3 n. 17 (W. D. Tex. Aug. 31, 2005).

plaintiff/appellee's class action claims were not subject to arbitration because of Rule 10301); Pecan East Antonio Investors, Inc., 2005 WL 2105751 at *3-*8 (members of putative class action pending in another district who filed case in federal court were not required to arbitrate claims because, while the parties agreed to arbitrate claims, "the parties also agreed to limit the enforceability of the agreement to arbitrate in those situations when class certification proceedings are pending").

As the U.S. District Court for the District of Minnesota recently recognized, Rule 10301 applies not only to absent class members who file court cases while a class action is pending, but also to "those who have initiated class actions" such as plaintiffs herein. Good v. Ameriprise Financial, Inc., No. 06-1027 (PJS/RLE), 2007 WL 628196 at *2 (D. Minn. Feb. 8, 2007). The Good Court rejected a defense contention that because plaintiffs had signed a waiver of their ability to participate in class actions, they had contracted out of Rule 10301. Id. As here, under the clear language of Rule 10301 the Good plaintiffs were fully eligible to commence a class action, notwithstanding having contracted to arbitrate their individual claims.

Based on Rule 10301, it is clear that the class action claims herein are not arbitrable, and simply could not have been arbitrated at any relevant time. Where, as here, there is and was no arbitrable claim, the FAA is irrelevant.

The district court rationalized that the foregoing argument would only be applicable if plaintiffs had *initially* filed a class action, rather than initiating arbitration proceedings. (JA A194). But this is an illusory possibility, as plaintiffs had no way of knowing about Morgan Stanley's pervasive misconduct when they filed their arbitration cases (nor, indeed, until the cases were already over). Further, since Morgan Stanley's fraudulent conduct occurred during the arbitration proceedings, it was a fallacy for the district court to suggest that plaintiffs could have availed themselves of the protections of Rule 10301 by filing a class action (charging misconduct that had yet to occur).

This is a case where plaintiffs have commenced a class action case in court after finding out about Morgan Stanley's pervasive wrongdoing. The district court has effectively enforced an arbitration agreement against plaintiffs with respect to claims that are not arbitrable, in violation of Rule 10301.

C. The FAA is inapplicable because this class action is not (and never was) an arbitrable claim under plaintiffs' contracts with Morgan Stanley.

Even if these class action claims were arbitrable under NYSE and NASD rules, the claims can be filed in court because they are not arbitrable under Morgan Stanley's standard customer agreement. Morgan Stanley's standard arbitration clause, offered to customers on a "take it or leave it" basis, provides as follows:

> Arbitration of Controversies
>
> You agree that all controversies between you or your principals or agents (including affiliated corporations) arising out of or concerning any of your accounts, orders or transactions, or the construction, performance, or breach of this or any other agreement between us, whether entered into before or after the date an account is opened, shall be determined by arbitration before the New York Stock Exchange, Inc., the National Association of Securities Dealers, Inc.; or the Municipal Securities Rulemaking Board, as you may elect.

(JA A136).

Thus, of the claims asserted in this class action, only the breach of contract claim is even within the scope of the claims that are required to be arbitrated based on the plain language of Morgan Stanley's arbitration clause. Further, elsewhere in Morgan Stanley's standard contract, it is clarified that even claims that would otherwise be required to be arbitrated (such as breach of contract claims) are not eligible for arbitration if brought as a class action:

> Arbitration
>
> Arbitration Disclosures: Industry regulations require that the following disclosures appear in conjunction with the arbitration agreement which immediately follows:
>
> * * *
>
> f. No person shall bring a putative or certified class action to arbitration, nor seek to enforce any predispute arbitration agreement against any person who has initiated in court a putative class action, who is a member of a putative class who has not opted out of the class with respect to any claims encompassed by the putative class action until; (I) the class certification is denied; (ii) the class is decertified; or (iii) the customer is excluded from the class by the court. Such forbearance to enforce an agreement to

> arbitrate shall not constitute a waiver of any rights under this agreement except to the extent stated herein.

(JA A136).

Thus, under its own standardized customer agreement Morgan Stanley is prohibited from seeking to enforce arbitration against plaintiffs, who are persons "who [have] initiated in court a putative class action." See id.

It is well established that "[a]rbitration is entirely a creature of contract." Sole Resort, S.A. de C.V. v. Allure Resorts Management, LLC, 450 F.3d 100, 104 (2d Cir. 2006). The question of "which disputes are subject to arbitration," if any, is "determined entirely by an agreement between the parties .... Without the contract, the arbitration ... never could exist." Id.; see also Volt Info. Sciences v. Bd. of Trustees, 489 U.S. 468, 478, 109 S.Ct. 1384, 103 L.Ed.2d 685 (1989) ("[The Federal Arbitration Act] simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms."). Here, the very contract relied upon by Morgan Stanley in the district court makes it clear that plaintiffs' class action claims are not subject to arbitration (and therefore not subject to the FAA). Plaintiffs have previously brought arbitrable individual claims in arbitration. Now, they bring separate, non-arbitrable class action claims in court, and the FAA does not apply.

II. THE DISTRICT COURT ERRED IN FAILING TO PERMIT PLAINTIFFS TO PROSECUTE THEIR CLAIMS FOR MORGAN STANLEY'S STATUTORY VIOLATIONS THAT HAPPENED TO OCCUR DURING THE COURSE OF AN ARBITRATION PROCEEDING

The district court erred in failing to apply this Court's decision in Mian v. Donaldson, Lufkin & Jenrette Securities Corp., 7 F.3d 1085 (2d Cir. 1993) to permit plaintiffs to assert claims for a statutory violation notwithstanding the fact that the statutory violation happened to occur during the course of an arbitration proceeding. Plaintiffs quite simply do not seek to collaterally attack their arbitration awards in this case. Their claim is something quite different. The gravamen of plaintiffs' amended complaint is recovery for Morgan Stanley's repeated breach of its legal duties to plaintiffs, which violated their statutory rights under GBL §349. Plaintiffs were deprived of material information to which they were legally entitled and also injured due to Morgan Stanley's deceptive business practice of destroying evidence. Plaintiffs seek statutory damages that do not require them to prove that they "would" have won their arbitration cases absent wrongdoing by Morgan Stanley. Plaintiffs' claims are separately actionable under GBL §349, irrespective of the FAA, because Plaintiffs' harm flows from Morgan Stanley's deceptive acts and practices in and of themselves, not the impact they had on plaintiffs' arbitrations.

In Mian, this Court held that although the procedures established by 9 U.S.C. §§ 10 and 12 are normally the exclusive

remedy to challenge the results of an arbitration proceeding, Mian's failure to move to vacate the arbitration award within the time prescribed by 9 U.S.C. § 12 did not prevent him from seeking to recover damages pursuant to 42 U.S.C. § 1981 for alleged civil rights violations that occurred during the arbitration proceeding itself. Id. at 1086-87. This Court found that Mian's claim that the defendant securities firm violated his civil rights during an arbitration proceeding stood alone and apart from any statutory provision of the FAA because:

> [Section 1981] embraces protection of a legal process, and of a right of access to legal process, that will address and resolve contract-law claims without regard to race. In this respect, it prohibits discrimination that infects the legal process in ways that prevent one from enforcing contract rights, by reason of his or her race, [and it] covers wholly *private* efforts to impede access to the courts or obstruct nonjudicial methods of adjudicating disputes about the force of binding obligations, as well as discrimination by private parties . . . in enforcing the terms of a contract.

Id. (quoting Patterson v. McLean Credit Union, 491 U.S. 164, 177, 109 S.Ct. 2363, 2373, 105 L.Ed.2d 132 (1989)). This Court did not tether the significance of the Mian defendant's alleged violation of 42 U.S.C. § 1981 to the effect that it had, if any, on the outcome of the arbitration.

This case fits squarely within the Mian framework. GBL § 349 is a creature of statute based on broad consumer-protection concerns. Oswego, 85 N.Y.2d at *24-25. The statute was enacted initially to give the Attorney General enforcement power to curtail deceptive acts and practices – willful or otherwise –

directed at the consuming public. Owing to the "ever-changing types of false and deceptive business practices which plague consumers in our State," the Governor signed the measure into law (NY Dept of Law, Mem to Governor, Bill Jacket, L 1963, ch 813). In 1980, the Legislature took a significant step to expand the statute's enforcement scheme by allowing a private cause of action (GBL § 349[h]). GBL § 349, in its remedial nature, can be read to apply without exception. Section (g) of the statute states: "This section shall apply to *all* deceptive acts or practices declared to be unlawful, *whether or not subject to any other law of this state* . . ." (emphasis added). In Riordan v. Nationwide Mut. Fire Ins. Co., 756 F.Supp. 732, 741 (S.D.N.Y. 1990), the court stated, "there is every indication that the legislature intended the statute to apply to any business so as to effect its broad remedial purpose, notwithstanding the applicability of any other laws, so long as the elements of a claim under its provisions are satisfied."

As shown by its language and background, GBL § 349 is directed at wrongs against the consuming public. Like the statute at issue in Mian, GBL § 349 embraces an independent right of access to legal process to address those wrongs. Indeed, the Governor's memorandum in support of the bill indicates that by providing for a minimum damage recovery GBL § 349(h) is intended to encourage private suits. NY Legis Ann, 1980, p. 146. The

objective of Plaintiffs' claim under GBL § 349 is simply to hold Morgan Stanley accountable for its unlawful deceptive acts and practices. Under Mian, it is of no consequence that such acts and practices occurred during the adjudication of plaintiffs' disputes with Morgan Stanley over the handling of their securities accounts.

In Mian, this Court concluded that "[t]he fact that a major component of the damages sought would consist of the amount of the arbitration award - if the plaintiff can prove that but for the discrimination, the arbitrators would have ruled in his favor - does not mean that Mian's suit is one to challenge the award within the meaning of § 10 of the FAA." Mian, 7 F.3d at 1087. Here, plaintiffs seek statutory damages that do not require them to prove that they "would" have won their arbitration cases absent wrongdoing by Morgan Stanley. But, under Mian, even if plaintiffs sought damages for arbitration awards tainted by Morgan Stanley's deceptive acts and practices, their GBL § 349 claims could not be construed as a challenge to those awards under the FAA.

III. THE DISTRICT COURT ERRED IN EFFECTIVELY GRANTING MORGAN STANLEY SUMMARY JUDGMENT ON ITS AFFIRMATIVE DEFENSE OF RELEASE

A significant proportion of the putative class is composed of persons who signed general releases and/or settlement agreements in connection with settlement of their cases. For these Class Members, the FAA clearly cannot operate to preclude

their claims, as there is no arbitration award in effect. With respect to these class members who settled their cases[7], the district court failed to apply the standards applicable on a motion to dismiss and effectively granted summary judgment on its affirmative defense of release. It is true that a valid affirmative defense can defeat even a well-pleaded complaint. In re September 11 Property Damage and Business Loss Litigation, 481 F. Supp. 2d 253, 258 (S.D.N.Y. 2007). An "affirmative defense is normally asserted in an answer," but it may be raised on a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) where "the complaint itself establish[es] the circumstances required as a predicate to a finding" that the affirmative defense applies. McKenna v. Wright, 386 F.3d 432, 435 (2d Cir. 2004). However, defendants have the burden to plead the affirmative defense, by answer or by motion; the plaintiff is not required to allege facts to negate the affirmative defense. In re September 11, 481 F. Supp. 2d at 258[8].

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[7]While plaintiffs do not have statistical data concerning the proportion of the Class that is composed of persons who settled cases, NASD statistics show that approximately 52% to 63% of arbitration cases resolved in recent years have been resolved via settlement. See JA A164 (containing then-most-recent NASD Dispute Resolution statistics, available on the Internet at http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm). Thus, it is likely that over half of the Class herein is composed of persons who settled claims.

[8]; See also In re Global Crossing, Ltd. Securities Litigation, 313 F. Supp.2d 189 (S.D.N.Y. 2003) (no need to negate statutory affirmative defense in complaint); In re Turkcell Iletisim Hizmetler A.S. Securities Litigation, 202 F. Supp. 2d

If plaintiffs can prove that fraud permeated the arbitration and settlement process, then any agreements and releases that class members signed will be voidable under New York law. See Lobel v. Maimonides Medical Center, 39 A.D.3d 275, 835 N.Y.S.2d 28, 29 (1st Dep't 2007) (A release may be voided on the basis of fraud in the inducement, even when it results from prolonged negotiations by represented parties); see also Turkish v. Kasenetz, 27 F.3d 23, 28 (2d Cir. 1994) ("A party who has been fraudulently induced to settle a claim may either (1) rescind the settlement or (2) ratify the settlement, retain the proceeds, and institute an action to recover fraud damages").

Here, the district court effectively ruled that plaintiffs were constructively aware of Morgan Stanley's wrongdoing because Morgan Stanley sent letters to some of the plaintiffs (and to other arbitration claimants) in April 2005 and following indicating that Morgan Stanley had "recently come to appreciate" that Morgan Stanley had "additional sources [of e-mail] that might contain additional responsive email." (See, e.g., JA A48, A87, A96, A109). This is an effective grant of summary judgment, based on the self-serving documents proffered by Morgan Stanley that are neither referenced in nor integral to the complaint. See Global Network Commc'ns, Inc. v. City of New York, 458 F.3d 150, 154-56 (2d Cir. 2006) (reversible error to base Fed. R. Civ.

8, 12 (S.D.N.Y. 2001) (same).

P. 12(b)(6) dismissal on documents that are neither incorporated in nor integral to the complaint). "Thus, not only did the district court consider external material in its ruling, it relied on those materials to make a finding of fact that controverted the plaintiff's own factual assertions set out in its complaint." See id.

Further, based on the well-pleaded allegations of the complaint the Morgan Stanley letters were at best a self-serving misleading partial disclosure, as Morgan Stanley had not in fact (as it claimed in the letters) "recently come to appreciate" that it had a near-complete backup copy of its pre-October 2001 e-mail. Rather, it had recently decided to send out the letters as a litigation tactic after having known for 3 ½ years that it had a near-complete backup of its e-mail that it was deliberately concealing. The true facts concerning Morgan Stanley's fraud only emerged when the NASD filed its case in December 2006, whereupon plaintiffs (whose arbitration cases were by then over) promptly commenced this class action.

This Court should reverse the district court's effective grant of summary judgment based on its credulous acceptance of Morgan Stanley's self-serving letters as a purported "disclosure" of Morgan Stanley's pervasive fraudulent conduct.

IV. PLAINTIFFS SHOULD BE GRANTED AN OPPORTUNITY TO REPLEAD UNDER THE LIBERAL STANDARD FOR GRANTING LEAVE TO REPLEAD IN THIS CIRCUIT

Fed R. Civ. P. 15(a) specifies that "leave [to amend] shall

be freely given when justice so requires." The denial of a motion for leave to amend is reviewable for abuse of discretion. Slayton v American Express Co., 460 F.3d 215, 226 (2d Cir. 2006). The Supreme Court has made it clear that amendment should usually be permitted, and that a district court's refusal to grant leave without justification is "inconsistent with the spirit of the Federal Rules." Foman v. Davis, 371 U.S. 178, 182, 83 S.Ct. 227, 230, 9 L.Ed.2d 222 (1962).

Complaints dismissed under Rule 9(b) are "almost always" dismissed with leave to amend. Luce v. Edelstein, 802 F.2d 49, 56 (2d Cir. 1986), quoting 2 A J. Moore & J. Lucas, Moore's Federal Practice, 9.03 at 9-34 (2d ed. 1986). As long as a party has "at least colorable grounds for relief, justice does require" leave to amend. East Harlem Pilot Block-Building 1 Housing Development Fund Co. v. S.S. Silberblatt, Inc., 608 F.2d 28, 42 (2d Cir. 1979).

"In cases where such leave has not been granted, plaintiffs have usually already had one opportunity to plead fraud with greater specificity." Luce, 802 F.2d at 56, citing Armstrong v. McAlpin, 699 F.2d 79, 93-94 (2d Cir.1983); Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 115 (2d Cir. 1982). Here, plaintiffs have not had the opportunity to replead their fraud allegations in light of Morgan Stanley's reliance on the affirmative defense of release. In these circumstances the

district court's denial of an opportunity to replead based on its conclusion that "it is highly likely that any such effort would be futile" (JA A196-197) was an abuse of discretion. See Luce, 802 F.3d at 56, see also, Kaster v. Modification Systems, Inc., 731 F.2d 1014, 1018 (2d Cir. 1984).

CONCLUSION

For the foregoing reasons and authorities, plaintiffs respectfully request that the Court reverse the district court's December 3, 2007 Decision and Order to the extent that it dismissed plaintiffs' complaint and denied plaintiffs leave to replead, and remand this action to the district court for proceedings not inconsistent with this Court's disposition of this appeal.

Dated: New York, New York
March 13, 2008

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CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(a)(7)(C), I hereby certify that this brief was produced in Courier font (a monospaced typeface), 12-point type and contains 8,493 words (based on the WordPerfect word count function).

Dated: New York, New York
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See Second Circuit Local Rule 32(a)(1)(E)

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