

OCTOBER 2019

# Drill Baby Drill: Diversity Jurisdiction in the 21<sup>st</sup> Century



Getting in or out of federal court on the ground of diversity jurisdiction frequently involves exploring important citizenship issues seemingly below the surface. When they say drill baby drill, they could just as well be describing the 21<sup>st</sup> Century innovations in analyzing the presence of diversity of citizenship.

Before surveying the “below the surface” approach to citizenship issues in federal court, it is best to remember how important diversity can be. Almost from the beginning of the Republic, litigants could file actions in or remove them to federal court if there was complete diversity of citizenship between the parties — even if the case involved only state law claims.<sup>1</sup>

The diversity mining challenge starts with the established general proposition that there must be complete diversity of citizenship before an action can be filed or removed to federal court. As I have been teaching judges and lawyers for years, this essentially means writing down in columns the states of citizenships of all plaintiffs, the states of citizenship of all defendants and checking to be sure that the same state is not on both sides of the line.

## Citizenship Rules for Diversity Jurisdiction

The general rules governing citizenship determinations for diversity actions are easy to state. These rules can be summarized as follows:

### a. Individuals

For diversity purposes, natural persons are considered to be citizens of the state in which they are domiciled (not merely residing)—meaning where they are and intend to remain permanently. Ordinarily, this poses no analytic challenge unless someone has multiple residences or is

temporarily located somewhere (e.g. students, military personnel, prisoners, etc.).<sup>2</sup>

In close cases, courts will drill down and examine the objective indicia in locating the person’s singular domicile. This means evaluating matters like primary residence, property ownership, voter registration, tax filings, etc. See The Wagstaffe Group Practice Guide: Fed. Civ. Proc. Before Trial, § 7-III[B][2][b].

### b. Corporations

Similarly, there are bright line rules established by statute and case law for determining the citizenship of corporations. Specifically, corporations are citizens for diversity purpose in every state in which they are incorporated and the state in which the entity has its principal place of business. [28 U.S.C. § 1332\(c\)\(1\)](#).

Determining an entity’s states of incorporation involves fairly shallow drilling. One identifies all states of incorporation and does not use the core sample of a State merely because the company is registered to do business there.

Discovering principal place of business “oil” is only slightly more complicated. The Supreme Court tells us to locate the entity’s “nerve center” — meaning where it conducts, coordinates and directs corporate activity at the highest level. This will most frequently equate with the company’s formal headquarters and not simply where the company is conducting its business, even if at its largest volume.<sup>3</sup>

### c. Non-Corporate Entities

The drilling effort becomes more complicated if parties on either side of the “v” line in litigation (i.e., plaintiffs or



defendants) are non-corporate entities (e.g. partnerships, LLCs, LLPs, unincorporated associations, etc.). In this situation under established law, the entity takes on the citizenship of each of its members, completely ignoring where it supposedly has its principal place of business or was formally created under law.<sup>4</sup> The drilling effort is extraordinarily important under a host of new federal court decisions.

First, one must ascertain whether the entity is, in fact, a corporation and thus limiting its citizenship to states of incorporation and principal place of business (and not where its shareholders, officers or directors are domiciled). When the entity's status is ambiguous, recent case law tells us that one must do, shall we say, a bit of "fracking" (i.e., examining the nature of the entity and whether it has the elements of "personhood" with shares issued to investors who enjoy limited liability).<sup>5</sup>

Second, the drill baby drill excavation becomes even more important when exploring the citizenship of these non-corporate artificial entities when they have sub-members below the surface. The following drilling rule often is overlooked: the citizenship inquiry means that if the non-corporate party has another artificial entity as a partner or member (e.g. one of the members of an LLC is itself an LLC) then you drill down again and include the members of the constituent entity as well. One circuit called this "a factor tree."<sup>6</sup>

Finally, the jurisdictional status of some entities has been unclear over the years. For example, it has only been in the last few years that courts have clarified the citizenship of trusts for diversity purposes. It was only

in 2016 that the U.S. Supreme Court clarified that the citizenship of business trusts (e.g., REITs) is that of each of their members as if they were a partnership.<sup>7</sup> On the other hand, if a party is a traditional trust characterized by fiduciary duties then the courts recently and uniformly have looked only to the citizenship of the trustee himself or herself for diversity purposes.<sup>8</sup>

### **Significance of the Drill Down Jurisdictional Exercise**

Importantly, therefore, if the citizenship of any non-corporate entity (meaning all its members and sub-members below the surface) is the same as anyone on the other side of the case, there is no complete diversity. Such cases cannot be originated in or removed to federal court on diversity grounds.

Simply put, the 21<sup>st</sup> Century diversity drilling exercise often will uncover a seemingly "irrelevant" sub-member of a non-corporate entity that will defeat complete diversity. For example, the citizenship of every partner—general, limited, silent—counts in assessing the presence of complete diversity. The same can be said for every member of an LLC, an LLP or an unincorporated association. If one constituent member of such an entity is from the same state as a party on the other side, then this drill down destroys complete diversity.<sup>9</sup>

A shockingly high number of cases in the past few years have resulted in dismissals (or remands) for the first time at the appellate stage when courts *sua sponte* have identified that, indeed, there may never have been complete diversity when the parties' citizenships are explored under the drill down approach.<sup>10</sup> This often happened because the lawyers

either were unaware of the drill down rules or simply did not know or investigate the citizenship of all the levels of their entity clients. (To be fair, sometimes due to privacy or other concerns, the client simply declines to disclose the citizenship of its more publicity-shy participants.)

The proposed amendment to Federal Rule of Civil Procedure 7.1 should address this problem and perhaps nip it in the bud. Lawyers are already familiar with the corporate disclosure requirement of existing Rule 7.1 designed to enable judges to conduct a conflicts analysis at the inception of cases. The amended rule would require that all parties to a diversity case file a disclosure statement that names and identifies the citizenship of every individual or entity whose citizenship is attributed to that party at the time the action is filed. Thus, the drill down rule could become a disclosure obligation at the very outset of the case—right when the “jurisdiction first” principle is most important.

### Survival Tips

Survival tips for such diversity drilling exploration are easy to identify and mandatory to follow.

1. Attorneys must conduct a reasonable investigation to identify the citizenship of all real parties in interest to determine if complete diversity exists.

2. Attorneys must also determine the citizenship of all members of non-corporate entities, including those in the sub-strata of ownership of such entities.
3. In performing their drilling tasks, attorneys must remember the “snapshot” rule, i.e., diversity of citizenship will be measured at the time jurisdiction is invoked, unaffected by later changes to such citizenship by relocation or changed ownership.
4. Finally, attorneys must convince their clients to join them as members of the “jurisdiction first society”—meaning it is essential to ascertain the citizenship of all parties (individuals, corporations and non-corporate members and sub-members) so as to avoid the utter waste of time and money when the absence of jurisdiction will mandate dismissal no matter how long the action has been pending in federal court.

At bottom, attorneys must be hyper-aware at the outset of potential citizenship issues, or risk having to write that truly awful email status report to a client explaining that the late-show jurisdiction defect means, in the blunt language of one appellate judge, that since there was no jurisdiction “from the get-go... close the hymnals because mass is over... Go home. Case dismissed.”<sup>11</sup>



### Authority you can trust, James M. Wagstaffe

Renowned author James M. Wagstaffe is a preeminent litigator, law professor and expert on pretrial federal civil procedure. He has authored and co-authored a number of publications, including *The Wagstaffe Group Practice Guide: Federal Civil Procedure Before Trial*, which includes embedded videos directly within the content on Lexis Advance. As one of the nation’s top authorities on federal civil procedure, Jim has been responsible for the development and delivery of federal law, and regularly educates federal judges and their respective clerk staffs. Jim also currently serves as the Chair of the Federal Judicial Center Foundation Board—a position appointed by the Chief Justice of the United States Supreme Court.

<sup>1</sup> See *The Wagstaffe Group Practice Guide: Fed. Civ. Proc. Before Trial*, Ch. 2 “State Versus Federal Procedures.”

<sup>2</sup> *Eckerberg v. Inter-State Studio & Publishing Co.*, 860 F.3d 1079 (8<sup>th</sup> Cir.2017) – that military person assigned to various places did not change his original Florida domicile.

<sup>3</sup> *Hertz Corp. v. Friend*, 559 U.S. 77, 93 (2010); *Bearbones, Inc. v. Peerless Indemnity Ins. Co.*, 2019 U.S. App. LEXIS 24908 (1<sup>st</sup> Cir. August 21, 2019)—court uses neurological metaphor of “corporate brain”; *3123 SMB LLC v. Hom*, 880 F.3d 461, 463 (9<sup>th</sup> Cir. 2018)—newly formed holding company’s nerve center is location of its board meetings.

<sup>4</sup> See *Carden v. Arkoma Assocs.*, 494 U.S. 185, 195 (1990)—count citizenship of all partners; *Siloam Springs Hotel, L.L.C. v. Century Surety Co.*, 781 F.3d 1233, 1237 (10<sup>th</sup> Cir. 2015)—same for LLCs; see also *The Wagstaffe Practice Guide: Fed. Civ. Proc. Before Trial*, § 7-III[D][3].

<sup>5</sup> See *Fellowes, Inc. v. Changzhou Xinrui Fellowes Office Equipment Co.*, 759 F.3d 787, 791 (7<sup>th</sup> Cir. 2014)—Chinese entity treated as LLC for diversity purposes; *Hawkins v. i-TV Digitalis Tavkozlesi zrt*, 2019 U.S. App. LEXIS 24311 (4<sup>th</sup> Cir. August 15, 2019)—if governing sovereignty treats entity as a corporation, it will be treated as such for diversity purposes—Hungarian kft—law unclear; *Puerto Rico v. Russell & Co.*, 288 U.S. 476, 481 (1933)—Puerto Rican sociedad en comandita treated as corporation;

*Hoagland ex rel. Midwest Transit, Inc. v. Sandberg, Phoenix & von Gontard, P.C.*, 385 F.3d 737, 739-43 (7<sup>th</sup> Cir. 2004)—professional corporation treated as corporation; see also *The Wagstaffe Group Practice Guide: Fed. Civ. Proc. Before Trial* § 7-III[C][2][b].

<sup>6</sup> *Purchasing Power, LLC v. Bluestem Brands, Inc.*, 851 F.3d 1218, 1220 (11<sup>th</sup> Cir. 2017).

<sup>7</sup> *Americold Realty Tr. v. ConAgra Foods, Inc.*, 136 S.Ct. 1012, 1016 (2016). See *The Wagstaffe Group Practice Guide: Fed. Civ. Proc. Before Trial* § 7-III[D][3][d].

<sup>8</sup> *Demarest v. HSBC Bank*, 920 F.3d 1223 (9<sup>th</sup> Cir. 2019); *GBForefront, L.P. v. Forefront Mg’t Group, LLC*, 888 F.3d 29 (3d Cir. 2018); *Raymond Loubier Irrevocable Trust v. Loubier*, 858 F.3d 719 (2<sup>nd</sup> Cir. 2017); *Byname v. Bank of New York Mellon*, 866 F.3d 351 (5<sup>th</sup> Cir. 2017); *Doemer v. Oxford Financial Group*, 884 F.3d 643 (7<sup>th</sup> Cir. 2018); *Wang v. New Mighty U.S. Trust*, 843 F.3d 487 (D.C. Cir. 2016).

<sup>9</sup> See Footnote 3, *supra*.

<sup>10</sup> See *Midcap Media Finance, L.L.C. v. Pathway Data, Inc.*, 929 F.3d 310 (5<sup>th</sup> Cir. 2019); *Purchasing Power, LLC v. Bluestem Brands, Inc.*, 851 F.3d 1218 (11<sup>th</sup> Cir. 2017); *Settlement Funding LLC v. Rapid Settlements, Limited*, 851 F.3d 530 (5<sup>th</sup> Cir. 2017).

<sup>11</sup> *Indiana Gas Co. v. Home Ins. Co.*, 141 F.3d 314, 320 (7<sup>th</sup> Cir. 1998) (Evans, J.).