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Expert Analysis

Recent Circuit Decisions Illustrate SLUSA's Limitations


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The Securities Litigation Uniform Standards Act of 1998 (SLUSA) was enacted as a supplement to the Private Securities Litigation Reform Act of the 1995 ("PSLRA") "to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]."[1] The central purpose of the PSLRA was to prevent abusive class actions brought with the hope that the expense of litigation may force defendants to settle despite the actions' lack of merit.[2] Since its enactment in 1998, SLUSA has twice been the focus of the U.S. Supreme Court's review.[3] District courts and circuit courts are still defining SLUSA's scope, but the trend appears to favor broader preservation of state law claims.

Two SLUSA issues that have not been addressed by the Supreme Court are (1) whether a covered class action that includes both claims within SLUSA's prohibition and claims beyond that prohibition must be dismissed in its entirety, and (2) the parameters of the so-called "Delaware carve-out" which excludes certain state law actions from the preclusive effects of SLUSA. The first issue was recently considered in *In re: Lord Abbett Mutual Funds Fee Litigation*, 553 F.3d 248 (3d Cir. 2009), in which the Third Circuit held that claims not precluded by SLUSA may not be dismissed. The second issue, one of first impression at the circuit court level, was addressed in *Madden v. Cowen & Company*, 556 F.3d 786 (9th Cir. 2009), in which the Ninth Circuit held that claims for negligent misrepresentation and professional negligence under California law in connection with a merger were within the Delaware carve-out and not precluded by SLUSA.

'Lord Abbett'

Based on allegations that the manager of and the investment adviser to a family of mutual funds charged existing investors excessive fees improperly used to pay brokers to market the funds, a proposed class of shareholders asserted claimed violations of §§36(b) and 48(a) of the Investment Company Act of 1940 as well as four state law claims. In an initial ruling, the district court dismissed the four state claims as preempted by SLUSA and dismissed, without prejudice, the claims under §36(b) based upon the absence of a direct cause of action on behalf of fund shareholders and under §48(a) because of the absence of a predicate claim under §36(b).

The plaintiffs then filed an amended complaint asserting only two derivative claims alleging violations of §§36(b) and 48(a). The defendants again moved to dismiss, arguing that SLUSA required the dismissal of the entire action, not just the preempted claims.[4] The district court granted that motion,[5] referring to the Third Circuit's earlier decision in *Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294 (3d Cir. 2005), as providing strong support, albeit in dicta, for the proposition that SLUSA preempts entire class actions rather than individual claims.

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After questioning, in *Rowinski*, whether preclusion of certain counts and remand of others is consistent with the plain meaning of SLUSA, which suggests that "if any claims in a covered class action are preempted, the entire action must be dismissed,"[6] the Third Circuit found in *Lord Abbett*, that "[t]he plain language of SLUSA does not clearly indicate whether Congress intended SLUSA to preempt entire actions that include an offending state-law claim."[7]

The Third Circuit focused on the fact that the term "covered class action" is modified by the phrase "based upon the statutory or common law of any State" and SLUSA does not refer to actions based in part on state law.

Having found that statutory ambiguity, the Third Circuit turned to SLUSA's legislative history and found no guidance as to the intent of Congress on this issue. However, the court "struggle[d] to see how permitting federal claims that do not specifically trigger the SLUSA preemption to proceed would lead to either abusive litigation or to the application of different legal standards to notional securities."[8]

Although dismissal of an entire action pursuant to SLUSA might deter class action plaintiffs and their attorneys from attempting to test the boundaries of which individual state law claims are pre-empted by SLUSA, the Third Circuit pointed out that nothing in either the plain language of the statute or its legislative history suggests that Congress intended SLUSA to have such a punitive effect.

Finding that neither the plain language nor the legislative history supported the dismissal of all claims, and that the purpose of SLUSA was not inconsistent with permitting non-prohibited claims to proceed, the Third Circuit held that SLUSA did not mandate dismissal of the entire action.

By permitting the non-precluded claims to stand, the Third Circuit aligned itself with the views of the Second Circuit, as expressed in its decision in *Dabit*,[9] which remains the law in the Second Circuit on this issue despite *Dabit*'s subsequent reversal by the Supreme Court on other grounds.[10] In a recent Tenth Circuit decision, *Anderson v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 521 F.3d 1278 (10th Cir. 2008), the court also considered the issue, citing *Rowinski* and the district court's decision in *Lord Abbett* as possible support for dismissal of an entire action under SLUSA, but did not find it necessary to decide the issue, dismissing the entire complaint because plaintiffs had incorporated the offending allegations into each of their substantive counts.[11]

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'Madden'

The "Delaware carve-out" preserves certain state-law actions from the preclusive effect of SLUSA, even though asserted in a covered class action and involving a covered security, both as defined in SLUSA. Among those preserved claims are those "based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity)." 15 U.S.C. §77p(d)(1)(A). To qualify the action must involve:

(i) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

(ii) any recommendation, position, or other communication with respect to the sale of securities of the issuer that—

I) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

II) concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

15 U.S.C. §77p(d)(1)B.

As the Supreme Court explained in *Kircher*, if a federal court determines that the action may be maintained in state court pursuant to the Delaware carve-out, "the Federal court shall remand such action to such State court."[12] *Madden* represents the first appellate decision on the Delaware carve-out issue and underscores the breadth of the provision.

Initially, although the 63 plaintiffs in *Madden* sued individually rather than as a traditional class, it nonetheless fell within the definition of a covered class action, which encompasses an action in which "damages are sought on behalf of more than 50 persons."[13] The plaintiffs in *Madden* were shareholders of St. Joseph Medical Corporation which owned a controlling share of Orange Coast Managed Care Services. The combined management of St. Joseph and Orange formed a special committee to seek a buyer for the two companies and retained Cowen & Company, an investment bank, to identify prospective buyers, to provide advice regarding the structure of the transaction, and to provide a "fairness opinion" regarding any proposed transaction.

One of the potential buyers identified was FPA Medical Management, which was recommended by Cowen. Subsequently, FPA acquired all outstanding shares of St. Joseph and, as a result, acquired a controlling interest in Orange. Cowen concluded that the transaction would be financially fair to St. Joseph's shareholders.

After receipt of a registration statement that included Cowen's fairness opinion, the plaintiffs voted in favor of the merger transaction. Several months later, FPA issued a "calamitous" first-quarter report and, two months later, declared bankruptcy. The plaintiffs commenced an action in California state court alleging that Cowen was liable for negligent misrepresentation and professional negligence.

Cowen removed the action to the federal district court and moved to dismiss under SLUSA, while the plaintiffs moved to remand relying on the Delaware carve-out. The district court granted Cowen's motion and denied the plaintiffs' motion, and the plaintiffs appealed to the Ninth Circuit.[14]

On appeal, the plaintiffs argued, as they had in the district court, that their action was a preserved claim under SLUSA because it was based on the common law of California (the state in which the issuer (St. Joseph) was incorporated and involved a recommendation or communication with respect to the sale of securities of the issuer, St. Joseph, made on behalf of St. Joseph, and which concerned decisions of its stockholders in connection with their vote in favor of the merger.

Cowen argued that St. Joseph was not "the issuer" referred to in the Delaware carve-out and disputed that Cowen was acting "on behalf of" St. Joseph when it provided its fairness opinion. The Ninth Circuit rejected both arguments by Cowen, and remanded the case to the district court with instructions to remand the action to state court.

With respect to the first issue, Cowen argued that only FPA was the issuer of a covered security (the shares of St. Joseph and Orange being privately held) and, for that reason, the Delaware carve-out did not apply. The Ninth Circuit disagreed, explaining that the carve-out does not define the "issuer" to mean an "issuer of covered securities," and refers only to "securities" or "equity securities," concluding that the carve-out allows a shareholder to bring a covered class action under state law against any "issuer," or anyone acting on behalf of the issuer, that has made certain communications regarding the sale of the issuer's securities and that these securities need not be the "covered securities" referred to in §77p(b). In doing so, the Ninth Circuit relied upon the plain language of the statute and rejected Cowen's argument that the legislative history suggested a Congressional intent to limit the carve-out to suits against issuers of "covered securities."

With respect to the second issue, whether Cowen was acting "on behalf of" St. Joseph when it provided its fairness opinion, the Ninth Circuit disagreed with Cowen's argument that the court should use the PSLRA definition, which defines the phrase "person acting on behalf of an issuer" to mean "an officer, director, or employee of the issuer." 15 U.S.C. §77z-2(i)(6). That definition, taken from the PSLRA's safe harbor rule for those making forward-looking statements, was rejected in favor of the plain meaning of the words used in SLUSA and the common sense interpretation of those words, which include "in the interest of," "as a representative of," and "for the benefit of."

Having concluded that the words "on behalf of," as used in the Delaware carve-out, have an unambiguous, common sense meaning, the Ninth Circuit saw no reason to look to other statutes that Congress chose not to cross-reference. The court also pointed out that the complaint alleged that Cowen was retained by a special committee whose members were directors of St. Joseph and Orange and that the fairness opinion was provided, with Cowen's consent, to the shareholders of St. Joseph who relied on it when voting in favor of the merger.

Future Impact

The growing body of circuit court decisions allowing the preservation of non-precluded claims in dual claim cases provides a clear road-map for plaintiffs' attorneys to avoid complete dismissal of their class actions under SLUSA. Whether the Third Circuit's dicta in *Rowinski* can be squared with its use of "plain meaning" statutory construction in *Lord Abbett* is questionable, and may provide a basis for subsequent challenge in other circuits that have not addressed the issue. Further action by Congress to further limit state law claims by statutory amendment is unlikely in this economic environment.

In parallel, the boundaries of the Delaware carve-out are largely unexplored at the appellate level, but appear to be headed in the same direction, the broad preservation of state law claims. The Delaware carve-out undoubtedly will be the subject of future judicial analysis as the volume of securities litigation grows in response to the continuing tumult in our capital markets.

1. SLUSA, S. 1260, 105th Cong. §2(5), 112 Stat. 3227.
2. S. Rep. 104-98 (1995).
3. See *Merrill, Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006) (broadly interpreting SLUSA's "in connection with" requirement) and *Kircher v. Putnam Funds Trust*, 547 U.S. 633 (2006) (holding that a district court's decision to remand an action challenged under SLUSA was not appealable to the Circuit Court).
4. As the Supreme Court subsequently explained in *Dabit*, SLUSA does not actually "pre-empt" claims but merely "denies plaintiffs the right to use the class-action device to vindicate certain claims." 547 U.S. at 87.
5. *In re Lord Abbett Mut. Funds Fee Litig.*, 463 F. Supp. 2d 505 (D.N.J. 2006).
6. 398 F.3d at 305.
7. 553 F.3d at 254.
8. Id.
9. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 395 F.3d 25 (2d Cir. 2005), rev'd on other grounds, 547 U.S. 71 (2006).
10. See *LaSala v. Bank of Cyprus Pub. Co.*, 510 F. Supp. 2d 246, 274-75 n. 11 (S.D.N.Y. 2007).
11. *Anderson*, 521 F.3d at 1288 n. 6.
12. 547 U.S. at 644. See 15 U.S.C. §77p(d)(4).
13. 556 F.3d at 792. See 15 U.S.C. §77p(f)(2)(A)(i).
14. *Madden v. Cowen & Company*, 2007 WL 781780 (C.D. Cal. March 8, 2007).