Ninth Circuit Clarifies That Shareholders Can Sue a Company's Financial Advisors in State Court over Faulty Advice Under the Delaware Carve-out of SLUSA

In a decision that may expose financial advisors and others to increased securities litigation in state court, the Ninth Circuit recently ruled, in *Madden v. Cowen & Co.*, that shareholders of a company can sue the company's financial advisors in state court over faulty advice provided during mergers and other special situations under the Securities Litigation Uniform Standards Act (SLUSA). The court arguably expanded the application of the so-called "Delaware carve-out" to SLUSA's exclusive jurisdiction significantly. Ruling that the plain language of the statute allows a shareholder to bring a covered class action under state law against any "issuer"—or one that speaks on behalf of the issuer—that has made certain communications regarding the sale of its securities, the court also held that these securities need not be the "covered securities" referred to in SLUSA's preclusion provision.

Madden involved a group of sixty-three shareholders, which brought a state-law action against Cowen & Company and related entities (collectively, Cowen). The plaintiffs owned a majority interest in St. Joseph Medical Corporation (St. Joseph's), a California corporation, which in turn owned a controlling share in Orange Coast Managed Care Services (Orange Coast), a Delaware corporation. St. Joseph's and Orange Coast were both closely held corporations.

In 1997, the management of St. Joseph's and Orange Coast formed a special committee in order to seek out a buyer for the companies. In turn, the special committee retained Cowen, an investment bank, to solicit bids in connection with the sales process, provide advice regarding the sales structure, and provide a "fairness opinion" regarding any proposed transaction. Cowen solicited multiple bids, but eventually two emerged as frontrunners. St. Joseph's Hospital of Orange County (a part-owner of Orange Coast) offered $40 million for the company, with $30 million of that bid coming in the form of cash. The other bidder, FPA Medical Management (FPA), a publicly traded company, offered shares of its stock valued at $66.5 million, an amount that was eventually reduced to $60 million.

Cowen—which earned $50,000 plus one percent of the sale price—eventually recommended FPA, concluding that its proposed merger plan was financially fair to the shareholders of St. Joseph's and Orange Coast. Cowen issued a fairness opinion to that effect, which was filed with the SEC. In January of 1998, the boards of directors for St. Joseph's and Orange Coast approved the merger agreement, with the shareholders, relying on Cowen's fairness opinion, following suit.

Within months of the consummated merger FPA's price per share tumbled and it declared bankruptcy. When it declared bankruptcy, FPA's share price was approximately 0.5% of its value at the time of the merger agreement.

The plaintiffs brought an action against Cowen, alleging that it committed negligent representation and professional negligence under California law in connection with its role in the merger. Cowen removed the action to federal district court where, relying on SLUSA, the court denied the plaintiffs' motion to remand to state court and granted Cowen's motion to dismiss.

On appeal, the Ninth Circuit reversed the district court's holding and ordered the case remanded to state court. Cowen initially argued that the Delaware carve-out was inapplicable because St. Joseph's was not "the issuer" for purposes of the carve-out, which allows actions that are otherwise precluded under SLUSA to be brought based upon the law of the state in which the issuer is incorporated if certain legal requirements are met. Cowen claimed that "the issuer" in this context referred to the issuer of "covered securities" as defined in SLUSA, which in this case would be FPA, a publicly traded Delaware corporation, and not St. Joseph's, a California corporation. As a result, the Delaware carve-out would be inapplicable to the plaintiffs' suit, which was based on California law.

The court, however, dismissed this argument, finding that the statutory language used in SLUSA and the Delaware carve-out failed to support Cowen's contention. Rather, a plain reading of the statutory language supported a broader definition of the terms "issuer" and "covered securities." As a result, the court held that the Delaware carve-out allowed a shareholder to bring a covered class action under state law against "any issuer" that has made certain communications regarding the sale of its securities, and that such securities need not fall within the definition of "covered securities" as that phrase is used in SLUSA.

The court also took issue with Cowen's assertion that SLUSA's legislative history indicates that the Delaware carve-out was intended to apply only to issuers of "covered securities." The legislative intent in enacting the Delaware carve-out was not to limit its scope based on the type of security involved in the transaction, but rather, the court stated, "to preserve state-law actions brought by shareholders against their own corporations in connection with extraordinary corporate transactions requiring shareholder approval, such as mergers and tender offers, regardless of whether the corporations issued nationally traded securities."

The Ninth Circuit outlined the reasons why Cowen's limited reading of the Delaware carve-out would yield illogical results. "Under Cowen's interpretation of the statute," the court reasoned, "St. Joseph's shareholders are deprived of their state-law remedy against St. Joseph because it agreed to exchange its securities with a corporation that issued nationally traded securities instead of with a closely held corporation." However, the shareholders' action would be viable under the Delaware carve-out if their corporation agreed to exchange stock with another closely held corporation, or even if their corporation issued nationally traded, covered securities, in which case St. Joseph's would qualify as "the issuer" under Cowen's definition. The Ninth Circuit deemed this result, in which the plaintiffs were precluded from maintaining their action simply because their company did not issue covered securities, unreasonable and contrary to the spirit of the Delaware carve-out.

In addition to advocating for a limited reading of the statutory language at issue, Cowen argued in the alternative that it had not made the statements in its fairness opinion on behalf of St. Joseph's, and therefore the plaintiffs' claim failed to meet that element of the Delaware carve-out statute. The court all but summarily dismissed this argument, finding that the plain meaning of the phrase "on behalf of" supported the notion that Cowen's statements were made to St. Joseph's shareholders in the interest of, or as a representative of, St. Joseph's, which paid Cowen to issue the opinion.

Madden v. Cowen & Co. clarifies—and in so doing may expand—the scope of the Delaware carve-out, which creates a distinct avenue for securities litigation plaintiffs seeking to bring their claim in state court. Financial advisors to all types of issuers seeking shareholder approval should take note of the decision in assessing the litigation risks around such transactions.

To learn more, please contact any of our Securities Litigation attorneys or your Ropes & Gray advisor.

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