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Litigating Securities Class Actions After Cyan: Guidance for Limiting Client Exposure and Controlling Venue

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AFTER *CYAN*: LITIGATING '33 ACT CASES IN STATE COURT

January 30, 2019

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AGENDA

- How we got to *Cyan*
  - The differences between the ’33 and ’34 Acts
  - The Reform Act and SLUSA
  - The split in the courts
  - *Cyan*
- What’s the problem?
  - Multiplicity of litigation
  - Differences between federal and state courts
- Other attempts to address
- Litigating in state courts

FEDERAL SECURITIES STATUTES

- Securities Act of 1933
  - Governs claims based on registration statements for public offerings
  - Lower pleading burdens on plaintiffs
  - But class of plaintiffs is narrower
    - Only those who bought the securities issued in the challenged offering may maintain a claim
    - Damages limitation
  - Concurrent jurisdiction in federal and state courts, but cases filed in state court could not be removed

FEDERAL SECURITIES STATUTES (CONT.)

- Securities Exchange Act of 1934
  - Higher pleading standards (scienter)
  - Available to after-market purchasers
  - Majority of cases
  - Exclusive federal jurisdiction

THE REFORM ACT AND SLUSA

- The Private Securities Litigation Reform Act of 1995 significantly amended the securities laws, made it tougher for plaintiffs
  - Lead plaintiff process, with the court selecting the movant with the largest financial interest in the case as the lead plaintiff
  - Mandatory stay of discovery
  - Higher pleading standards for scienter and falsity
  - Safe harbor for forward-looking statements
  - Plaintiffs start filing more cases in state courts

THE REFORM ACT AND SLUSA (CONT.)

- Securities Litigation Uniform Standards Act of 1998
  - Foreclosed most class actions in state court under state law by allowing removal to federal court and then dismissal
  - Made changes to the jurisdictional provision of the '33 Act
    - "*Except as provided in section 77p(c) of this title [which was added by SLUSA]*, no case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed" to federal court
    - "The district courts of the United States... shall have jurisdiction[,] concurrent with State and Territorial courts, *except as provided in section 77p of this title with respect to covered class actions . . .*"

DID SLUSA CHANGE THE JURISDICTION OF STATE COURTS IN '33 ACT CLASS ACTIONS?

- Split in the federal courts
  - Some federal courts (notably in New York and New Jersey) said yes, and held that class actions in state court could be removed to federal court
  - Some federal courts (notably in California) said no, that state courts retained jurisdiction and the cases were still not removable
    - California state courts held that state courts retained jurisdiction
- Because a federal court's decision on a motion to remand a removed case is not an appealable order, the split in the District Courts was not ripening into decisions from the federal courts of appeals

THE INCREASE IN '33 ACT CASES IN STATE COURTS

- The ability to file in state court led to more filings there, particularly in California
  - From July 2011 to September 2016, 42 class actions with '33 Act claims were filed in California state court (charts in *Cyan*'s *cert* petition)
  - According to Cornerstone Research, between 2010 and the first half of 2018, 60 class actions with '33 Act claims were filed in California state court
- California became something of a magnet for these cases
  - Some companies not based in California were named in cases filed in California state courts
  - No ability to transfer a case from one state's court to another (unlike the ability to move to transfer from one federal district court to another)

WHY WOULD PLAINTIFFS WANT TO FILE IN STATE COURTS?

- Lead plaintiff provisions do not apply in state court
  - Case can proceed faster in early stages (as there is not the several months of a lead plaintiff process before an operative complaint is on file)
  - Some plaintiffs' firm may view it as an opportunity to avoid losing out on a case because a counsel with a plaintiff with a larger loss would otherwise win a lead plaintiff battle
    - Creates more of a "race to the courthouse" as existed before the Reform Act created the lead plaintiff process
    - Gives somebody else a "seat at the table" if there are duplicative cases
- State courts viewed as less willing to grant motions to dismiss

WHY WOULD PLAINTIFFS WANT TO FILE IN STATE COURTS? (CONT.)

- State courts viewed as more willing to allow broader discovery
  - If a state court does not apply the Reform Act discovery stay, a plaintiff need not get past a motion to dismiss before conducting discovery
- Factors above all create more pressure on defendants to settle – and for more

CYAN: BACKGROUND

- *Cyan* conducted its initial public offering in 2013
- *Cyan*, its directors and officers, and IPO underwriters were sued in California Superior Court in San Francisco in 2014
- Motion for judgment on the pleadings for lack of jurisdiction denied October 2015
- Writ petition filed in California Court of Appeal, denied December 2015
- California Supreme Court denied review (Feb. 2016)
- *Cert.* petition filed with the US Supreme Court (May 2016)
- U.S. Supreme Court asks for the views of the Solicitor General (Oct. 2016)
  - SG urges that *cert.* be granted and that the Court find that state courts retain jurisdiction over '33 Act class actions but that the cases are removable to federal court
- *Cert.* granted in June 2017

THE *CYAN* DECISION

- On March 20, 2018, the Supreme Court held 9-0 that state courts retain jurisdiction and that the cases are not removable
  - The Court held that "SLUSA's text, read most straightforwardly, leaves in place state courts' jurisdiction over 1933 Act claims, including when brought in class actions."
  - The Court held that changes in the statute relate to the ability to remove and ultimately dismiss claims brought under state law "But the section says nothing, and so does nothing, to deprive state courts of jurisdiction over class actions based on *federal* law."
  - The Court further noted that state court concurrent, non-removable jurisdiction had been in place for 65 years before SLUSA and so it is hard to believe that Congress would have "upended that entrenched practice not by any direct means, but instead by way of a conforming amendment…."
  - Despite policy considerations and that "[w]e do not know why Congress declined to require as well that 1933 Act class actions be brought in federal court . . ." the Court would "not revise that legislative choice, by reading a conforming amendment and a definition in a most improbable way, in an effort to make the world of securities litigation more consistent or pure."

WHAT'S THE PROBLEM?

- Multiplicity of litigation: Similar or overlapping cases in state and federal courts
- Some provisions available in federal court don't apply in state court or state courts have been inconsistent
- State courts perceived as more receptive to plaintiffs

MULTIPLICITY OF LITIGATION

- As noted above, federal courts have exclusive jurisdiction over cases under the ’34 Act, while state courts have concurrent non-removable jurisdiction over claims under the ’33 Act
- Defendants may end up facing similar claims in separate courts
  - ’33 Act case(s) in state court and a ’34 Act case in federal court
  - Federal court hears claims under ’33 and ’34 Acts, while there is a parallel ’33 Act case in state court
  - ’33 Act cases in multiple states (with or without federal analogues) and no ability to transferor use an MDL procedure
- Motions to stay state cases in deference to federal cases have had a mixed reception in state court

WHAT APPLIES IN STATE COURT AND WHAT DOESN'T?

- Lead plaintiff provisions
  - The Court in *Cyan* noted that the lead plaintiff provisions, which expressly mention FRCP 23, are among those "applied only . . . in federal court"
  - But useful in the event of multiple cases/plaintiffs
- Discovery stay
  - Should apply in state court: statute provides that "In any private action arising under this title, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, . . ."
  - Law is mixed in California, with more recent cases generally finding it inapplicable
- Pleading standards
  - Should federal pleading standards apply?
  - Many states have retained the notice pleading approach rejected by the US Supreme Court in *Twombly* and *Iqbal*

WHAT APPLIES IN STATE COURT AND WHAT DOESN'T? (CONT.)

- Substantive law
  - Federal law governs, but there are always concerns particularly given that the '33 Act has virtually strict liability for the issuer
- Statute of limitations
  - Federal law governs
- Settlement procedures
  - The Reform Act mandates certain disclosures to class members. Those provisions expressly mention FRCP 23, so akin to the lead plaintiff provisions mentioned in *Cyan*, these provisions do not apply
  - Most states have procedures for class settlements similar to those of federal law, but diligent defense counsel should aim to have the process comply as much as possible with federal practice to head off problems

AFTER *CYAN*, OTHER ATTEMPTS TO ADDRESS THE ISSUE HAVE YET TO SUCCEED

- Some companies have included a provision in their certificate of incorporation or bylaws mandating cases under the '33 Act be filed in U.S. District Court
  - In *Sciabacucchi* v. *Salzberg*, (Dec. 19, 2018), Delaware Court of Chancery held such provisions invalid under Delaware law
  - A notice of appeal has been filed, so the issue will be decided by the Delaware Supreme Court
  - Many companies with such a provision have filed notices to the effect that they will not enforce it unless the decision is reversed
  - What might other states do?
- Will Congress amend the '33 Act?

EFFORTS TO REDUCE '33 ACT EXPOSURE BY NARROWING LOCK UPS

- Standing under Section 11 of the '33 Act is limited to those who purchased shares that were issued pursuant to the challenged registration statement
  - This means that the only those who bought directly in the offering or who can "trace" their shares to it have a claim
  - Where the challenged offering is of a company that already has stock trading in the market and the offering merely adds more stock, tracing is virtually impossible for purchasers in the after-market. Thus, only those who purchased directly in the offering have a claim
- Traditionally, IPOs have had "lock-up" agreements, which restrict pre-IPO shareholders from selling any stock for months after the IPO
  - The prospect of facing a '33 Act claim in state court is making some rethink traditional practices concerning lock-ups, such as making them shorter or more limited

IMPACT ON D&O INSURANCE

- The costs of ’33 Act class actions in state court has led to a significant changes in the D&O market
  - D&O insurers have felt burned by these cases, which had greater costs and settlements
- Self-insured retentions have gone up substantially, particularly for newly-public companies
- Some insurers have become much less willing to insure IPOs or be primary insurer on them

ADDITIONAL CONSIDERATIONS FOR LITIGATING '33 ACT CASES IN STATE COURT

- Beware of federal-court-itis
  - Even if you would prefer to be in federal court, avoid doing anything to make it appear that you do not respect the state court
- Know your audience and its rules
  - Securities litigation has largely taken place in federal courts, and securities practitioners are more accustomed to its rules and practices
  - It is vital to know the applicable state rules and modes of practice
  - But do not be afraid to try to make new law – odds are you will need to

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