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

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Expert Q&A on Securities Act Claims and SLUSA After *Cyan*

Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA) to limit class plaintiffs' ability to bring certain securities class actions in state courts, thereby avoiding federal courts' more stringent substantive and procedural requirements. In *Cyan, Inc. v. Beaver County Employees Retirement Fund*, the US Supreme Court unanimously held that SLUSA's limitations do not apply to securities class actions brought only under the Securities Act of 1933 (Securities Act), which involves the public offering (as opposed to trading) of securities. Practical Law asked *David Rein* and *Matthew Schwartz* of *Sullivan & Cromwell LLP* to address how the *Cyan* decision changes the landscape for securities litigation and highlight likely trends that will follow in its wake.

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What are the key differences between Securities Act and Exchange Act claims?

The Securities Act is the principal federal statute governing securities offerings. Section 11 of the Securities Act permits plaintiffs to bring actions against corporate issuers and their underwriters for investment losses caused by material misstatements or omissions in securities offerings. Section 15 of the Securities Act extends liability to "controlling persons," such as directors and officers, who signed the registration statement associated with the securities offering.

By contrast, the Securities Exchange Act of 1934 (Exchange Act) is the principal federal statute governing securities trading. Courts have interpreted Section 10(b) of the Exchange Act and Securities and Exchange Commission (SEC) Rule 10b-5 to imply a private right of action for plaintiffs to redress investment losses caused by material misrepresentations or omissions that were made in connection with the purchase or sale of a security (17 C.F.R. § 240.10b-5). Additionally, Section 20(a) of the Exchange Act allows for control person claims. Unlike claims brought under the Securities Act, an Exchange Act plaintiff must show that the defendant had fraudulent intent and that the plaintiff relied on the misstatement.

Given the differences in the required mental state, claims under Section 11 of the Securities Act are sometimes referred to as "strict liability" claims.

Search Securities Litigation: Defending Against Control Person Claims for more on control person liability.

Search Securities Litigation: Mapping a Strategy for Defending Against Fraud Claims for more on claims under Section 10(b) and Rule 10b-5.

In other ways, however, Section 11 claims under the Securities Act have a far more restricted scope than Section 10(b) claims under the Exchange Act. Only a purchaser in a securities offering can bring a Section 11 claim based on the statements made in the offering registration statement. Accordingly, all Section 11 plaintiffs must "trace" their shares to the shares that were issued in the offering. In the world of modern trading, physical shares do not change hands in a manner that permits the tracing of specific shares so, as a practical matter, plaintiffs cannot bring Section 11 claims if there are other shares traded in the market that did not come from the challenged offering. Two potential sources of shares otherwise entering the market are:

- A follow-on offering.
- Aftermarket sales from corporate insiders who owned the shares before an initial public offering (IPO). These sales typically cannot occur until after the expiration of "lock-up" agreements between management and the underwriters. (*In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65, 117-18 (S.D.N.Y 2004), vacated on other grounds by 471 F.3d 24 (2d Cir. 2006).)

Exchange Act claims remain the primary vehicle to bring putative securities class action claims, in part because they are not limited by the tracing requirement. Additionally, Exchange Act claims often provide for larger potential damages awards than Securities Act claims.

Are all federal securities claims litigated in federal court?

No. Plaintiffs can choose to bring Securities Act claims in federal court or state court. Defendants typically may remove any federal claims filed in state court to federal court.

Search Removal: Overview for more on removing cases from state court to federal court.

However, in enacting the Securities Act, Congress expressly prohibited defendants from removing lawsuits brought exclusively under that Act from state court to federal court, though defendants were permitted to remove actions from state court that asserted claims under both the Securities Act and another federal law. Congress took the opposite approach when enacting the Exchange Act, providing that the federal courts have exclusive jurisdiction over Exchange Act claims.

Before *Cyan*, where were securities class action claims usually litigated?

As a result of the statutory framework described above, parties historically litigated securities fraud class claims brought under the Exchange Act exclusively in federal court, while class claims based on alleged misstatements in securities offerings under the Securities Act were litigated in both federal and state courts.

Congress later enacted the Private Securities Litigation Reform Act of 1995 (PSLRA) to regulate abusive securities litigation (109 Stat. 737). Among other things, the PSLRA imposed heightened pleading requirements, required an automatic stay of discovery pending adjudication of any motion to dismiss, imposed limitations on damages, and encouraged sanctions for frivolous actions. The PSLRA also instituted a process to award lead plaintiff status to the plaintiff with the greatest economic stake in the action, which was designed to reduce the then-common practice of lawyers racing to the courthouse to file claims on behalf of figurehead plaintiffs who lacked a significant stake in the litigation.

Search Securities Litigation Involving the Private Securities Litigation Reform Act for more on the PSLRA's provisions, as well as procedural and strategic issues parties should consider at key stages of a securities litigation involving the PSLRA.

To avoid the stringent requirements of the PSLRA, plaintiffs began filing securities actions asserting common law fraud or other state law theories in state court. To deter this new practice, in 1998, Congress passed SLUSA (15 U.S.C. § 78bb). Among other things, SLUSA provides that any "covered class actions," that is, actions asserting state law claims on behalf of more than 50 persons seeking damages in connection with any security traded on a national exchange, may be removed to federal court. After removal, the federal court should dismiss those claims as preempted by federal law.

How did courts interpret SLUSA when defendants sought to remove Securities Act claims?

Soon after Congress enacted SLUSA, federal courts began to split over whether SLUSA permitted defendants to remove claims under the Securities Act to federal court.

Two of the first courts to consider the issue held that defendants could not remove Securities Act claims because SLUSA provides for removal only of actions that are based on state statutory or common law. By contrast, federal law serves as the basis for Securities Act actions. (*Nauheim v. Interpublic Grp. of Cos.*, 2003 WL 1888843, at *4-5 (N.D. Ill. Apr. 16, 2003); *In re Waste Mgmt., Inc. Sec. Litig.*, 194 F. Supp. 2d 590, 594-96 (S.D. Tex. 2002).)

District courts in California generally followed this approach, holding that defendants cannot remove Securities Act claims from state court (see, for example, *Badri v. TerraForm Global, Inc.*, 2016 WL 827372, at *3-4 (N.D. Cal. Mar. 3, 2016); *City of Warren Police & Fire Ret. Sys. v. Revance Therapeutics, Inc.*, 125 F. Supp. 3d 917, 920-21 (N.D. Cal. 2015); but see, for example, *Brody v. Homestore, Inc.*, 240 F. Supp. 2d 1122, 1124 (C.D. Cal. 2003) (holding that Securities Act actions could be removed under SLUSA based on the language and purposes of the statute)).

Other courts, including district courts in New York, New Jersey, and Ohio, disagreed, interpreting SLUSA to permit, and often even to require, defendants to remove Securities Act claims from state court (see, for example, *Knox v. Agria Corp.*, 613 F. Supp. 2d 419, 422-25 (S.D.N.Y. 2009); *Pinto v. Vonage Holdings Corp.*, 2007 WL 1381746, at *2 (D.N.J. May 7, 2007); *Kulinski v. Am. Elec. Power Co.*, 2004 WL 7324733, at *2-3 (S.D. Ohio Jan. 7, 2004) (overruling an objection to a magistrate judge's report)).

As a result of the different approaches, the frequency of Securities Act lawsuits in California state courts substantially increased, especially in counties perceived to be plaintiff-friendly. One study, for example, found that there were 18 actions asserting Section 11 claims filed in California state court in 2016 and 15 in 2015, compared with one to five filings per year in earlier years (Cornerstone Research, Securities Class Action Filings Rise to Highest Level in 20 Years (Jan. 31, 2017)).

Because decisions on remand motions generally are not appealable, the nationwide split continued to deepen over the two decades following SLUSA's passage. The Supreme Court sought to resolve this split in *Cyan, Inc. v. Beaver County Employees Retirement Fund* (138 S. Ct. 1061 (2018)).

What was the Supreme Court's holding in *Cyan*?

In *Cyan*, a unanimous Supreme Court ruled that:

- Investors in securities offerings who assert class action claims under the Securities Act can continue to bring those claims in state court if the action asserts only claims under the Securities Act.
- Defendants cannot remove class actions asserting only Securities Act claims to federal court.

In its decision, authored by Justice Kagan, the Court reasoned that SLUSA's amendments to the Securities Act do not deprive state courts of jurisdiction over covered class actions that assert only Securities Act claims. The Court rejected the petitioner's argument that SLUSA's amendment of the jurisdictional provision in the Securities Act abrogated state court jurisdiction over Securities Act claims, stating that Congress could have used more precise language if it had intended to provide an exception to state court jurisdiction. (*Cyan*, 138 S. Ct. at 1069-71.)

The Court concluded that the petitioner's arguments about the legislative history and purpose behind the relevant amendments to the Securities Act failed to overcome the clear statutory language, noting that the Court had no license to disregard clear language and intuit that Congress must have intended for Securities Act class actions to be litigated only in federal court. The Court acknowledged that it did not know why Congress declined to treat Securities Act class actions like class actions under the Exchange Act, which must be brought in federal court, but declined to revise that legislative choice. (*Cyan*, 138 S. Ct. at 1072-74.)

Having found that state courts maintain jurisdiction over class actions arising under the Securities Act, the Court next addressed the arguments raised by the US Solicitor General in an *amicus* brief. The Solicitor General had proposed that the Court interpret SLUSA to permit a defendant to remove Securities Act class actions to federal court as long as the action alleged "false statements or deceptive devices in connection with a covered security's purchase or sale." The Court held that its prior decision in *Kircher v. Putnam Funds Trust* foreclosed that possibility. (*Cyan*, 138 S. Ct. at 1075-76 (citing *Kircher*, 547 U.S. 633 (2006)) (noting that the Court concluded in *Kircher* that "removal is limited to those [actions] precluded by the terms of subsection (b)" of SLUSA).) According to the Court, SLUSA permits defendants to remove only class actions that are based on state law for the specific purpose of enforcing the dismissal of those actions required by SLUSA, not class actions based on federal law (*Cyan*, 138 S. Ct. at 1077-78).

Notably, *Cyan* does not affect the litigation of Exchange Act claims in federal courts.

What impact do you predict this decision will have on securities litigation?

First, given the certainty *Cyan* provides to plaintiffs that their cases will not be removed, it seems likely that more Securities Act class actions will be filed in state courts. This trend could be bolstered by plaintiffs' expectation that at least some of the PSLRA's more stringent requirements will not apply in state court. Additionally, plaintiffs' perception that they may be able to obtain more favorable outcomes in state courts, including at the critical motion to dismiss phase, will likely drive plaintiffs to file more frequently in state court.

For example, an *amicus* brief filed in *Cyan* by a group of law professors observed that federal courts dismissed 31% of Securities Act actions during 2011 to 2016, whereas California state courts dismissed only 6% of Securities Act actions over the same period (Brief for Law Professors as Amici Curiae in Support of Petitioners at 21, *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, 138 S. Ct. 1061 (2018) (No. 15-1439), 2017 WL 4082013).

Search Securities Litigation: Motion to Dismiss Fraud Claims Memorandum of Law for a sample brief counsel can use when moving to dismiss a securities fraud lawsuit, with explanatory notes and drafting tips.

Second, Section 11 actions may increasingly be filed in state courts around the country beyond California. Following a tactic previously deployed in merger challenge lawsuits, plaintiffs' lawyers may attempt to find particularly plaintiff-friendly jurisdictions. Over time, these efforts may lead to inconsistent interpretations of the Securities Act across different state courts.

This type of potential increased risk and uncertainty for issuers may reduce corporate interest in raising capital through IPOs in US markets. Already, almost 18% of IPOs are challenged under the Securities Act within four years of the offering (Cornerstone Research, Securities Class Action Filings, 2015 Year In Review, at 11). Given the publicly expressed desire of the Trump administration and SEC leadership to increase the number of IPOs, legislation or regulation to limit *Cyan*'s impact on forum shopping may be a future possibility.

Search Securities Litigation: Class Actions Arising from IPOs for information on the key attributes of securities class actions based on the offering materials for an IPO.

Third, defendants face an increased possibility of parallel Securities Act proceedings in multiple state and federal courts, as many of the federal court cases may also continue to assert Exchange Act claims. The potential for parallel proceedings will cause (and already has caused) complexity for all parties because state and federal courts, as further discussed below, sometimes follow different procedural and substantive rules for securities claims. Parallel proceedings may also incentivize plaintiffs to settle quicker and for less because they could face the risk of *res judicata* or collateral estoppel from other proceedings.

Additionally, it remains to be seen whether state courts will generally defer to federal courts to proceed first or vice versa, or whether courts will not defer, permitting parallel proceedings to go forward.

The collective impact of these likely trends should cause both plaintiffs and defendants to quickly determine the jurisdiction in which it is most likely to be advantageous for them to proceed and attempt to expedite cases pending in that jurisdiction. Because there is no national cross-state equivalent to the federal multidistrict litigation process to conduct pretrial proceedings in related cases on a consolidated or coordinated basis, organizations must stay agile to manage these proceedings, and deploy a variety of techniques, including filing motions to stay, motions to dismiss on *forum non conveniens* grounds, or motions to transfer venue.

Search Defending Parallel Proceedings: Key Considerations and Best Practices for information on key issues surrounding simultaneous investigations, litigations, or enforcement actions arising out of a common set of facts.

What key issues do you expect will be litigated in the wake of *Cyan*?

Disputes over the degree to which the PSLRA applies to Section 11 claims litigated in state court may become especially important. Some PSLRA requirements apply to any actions brought "pursuant to the Federal Rules of Civil Procedure," including the requirements concerning the lead plaintiff appointment procedures and limitations on damages and fee awards (15 U.S.C § 77z-1(a)). It remains to be seen whether state courts will apply these requirements, raising the possibility that, contrary to the core intent of the PSLRA, lawyers representing figurehead plaintiffs with minimal economic losses may be able to control Section 11 class action claims.

Other PSLRA requirements apply to "any private action" arising under the Securities Act, which defendants will argue includes state court actions. Among these requirements is the automatic stay of discovery under 15 U.S.C. § 77z-1. Whether this provision applies in state court is a question to which state courts have provided inconsistent answers (compare *Buelow v. Alibaba Grp. Holding Ltd.*, No. civ-535692 (Cal Super. Ct. Apr. 1, 2016) (refusing to stay proceedings) with *Milano v. Auhll*, 1996 WL 33398997, at *4 (Cal. Super. Ct. Oct. 2, 1996) (staying proceedings)).

What recommendations do you have for counsel representing corporations hoping to limit exposure to Securities Act claims in state court?

Prior to any offering, counsel should consider:

- Negotiating a lock-up period substantially shorter than the customary 180 days. This will reduce risk and exposure to Section 11 claims by targeting the tracing requirement.
- Carefully reviewing insurance policies, including directors and officers insurance policies and public offering of securities insurance (POSI) policies, before any offering. This review should focus on ensuring that the policies:
  - will cover claims based on pre- and post-offering activities; and
  - extend to potential state court claims.

Organizations may also consider including a forum selection clause in their articles of incorporation providing that federal court will be the exclusive venue for all Securities Act claims. However, plaintiffs are likely to challenge, both in court and before regulatory bodies, the validity of these amendments. These anticipated challenges increase the importance of the *Sciabacucchi v. Salzberg* case currently pending in Delaware, which addresses this issue (see *Sciabacucchi v. Salzberg*, No. 2017-0931 (Del. Ch., filed Dec. 29, 2017)).

Of course, every corporation's situation is different. Taking care with disclosures, retaining skilled advisors, and ensuring appropriate due diligence all help to reduce the risk of Securities Act exposure.

The authors appreciate the assistance of Marc-André Cyr and Tasha Thompson of Sullivan & Cromwell LLP in preparing these answers.