Expert Q&A: Securities Act Claims and SLUSA After Cyan

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An expert Q&A with David M.J. Rein and Matthew A. Schwartz of Sullivan & Cromwell LLP discussing the US Supreme Court's interpretation of the Securities Litigation Uniform Standards Act of 1998 (SLUSA) in Cyan, Inc. v. Beaver County Employees Retirement Fund and highlighting how the Cyan decision has changed the landscape for securities litigation.

WHAT ARE THE KEY DIFFERENCES BETWEEN SECURITIES ACT AND EXCHANGE ACT CLAIMS?

The Securities Act of 1933 (Securities Act) is the principal federal statute governing securities offerings. Section 11 of the Securities Act permits private 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 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 private claims brought under the Securities Act, private claims brought under the Exchange Act 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.

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, 117-20 (S.D.N.Y 2004), *vacated on other grounds by* 471 F.3d 24 (2d Cir. 2006).)

Exchange Act claims remain the primary vehicles to bring putative securities class action claims, in part because they are not limited by the tracing requirement and can be based on alleged material misstatements or omissions made outside the scope of a registration statement. Additionally, Exchange Act claims often provide for larger potential damages awards than Securities Act claims.

Different pleading rules apply to cases brought by the SEC (see, for example, *SEC v. Jammin Java Corp.*, 2016 WL 6595133, at *21 n.3 (C.D. Cal. July 18, 2016) (collecting cases for the proposition that the PSLRA's heightened pleading standards do not apply to actions brought by the SEC)). For more on securities enforcement proceedings, see Practice Note, Roadmap of the SEC's Investigation and Enforcement Process (W-000-3782).

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For more information on identifying securities class action claims under the federal securities laws, see Practice Note, Commencing a Securities Class Action: Identifying Claims (W-023-7361).

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 (for more information, see Practice Note, Removal: Overview (3-532-4248)).

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.

For resources on litigating claims under Section 10(b) of the Exchange Act and under the Securities Act, see Exchange Act: Section 10(b) Defense Toolkit (W-004-5011) and Securities Act: Federal Private Lawsuit Defense Toolkit (W-011-4405).

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 (Pub. L. 104-67, 109 Stat. 737 (1995)). 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.

For more information 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, see Practice Note, Securities Litigation Involving the Private Securities Litigation Reform Act (W-010-6738).

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 the Securities Litigation Uniform Standards Act of 1998 (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.

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- 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 1072-75.)

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 HAS THIS DECISION HAD ON SECURITIES LITIGATION?

First, given the certainty *Cyan* provides to plaintiffs that their cases will not be removed, more Securities Act class actions are being filed in state courts. Between 2010 and 2018, an average of only 12 Securities Act class actions were filed in state courts per year, including 13 actions in 2017, the year before the Supreme Court decided *Cyan* (Cornerstone Research, Securities Class Action Filings: 2019 Year in Review ("Cornerstone 2019 Review"), at 4, 19). By contrast, in 2018, the first year *Cyan* was in effect, plaintiffs filed 32 Securities Act class actions in state courts. Plaintiffs followed up with another 49 Securities Act class actions filings in state court in 2019 (Cornerstone 2019 Review at 4).

This trend may 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, is likely driving plaintiffs to file more frequently in state court.

For example, a study out of Stanford Law School found that, from 2011-2018, federal courts granted 42% of motions to dismiss Section 11 claims, whereas state courts granted only 19% of similar motions over the same period (Stanford Securities Litigation Analytics, State Section 11 Litigation in the Post-Cyan Environment ("Stanford Study"), October 2019, at 9-10).

Furthermore, a plaintiff that brings Securities Act claims in state court may face different pleading standards. As previously noted, Securities Act claims are generally not subject to heightened pleading standards. Some federal courts have recognized an exception to this general rule, if a plaintiff's Securities Act claim is premised on conduct that is associated with fraud rather than negligence (*Rombach v. Chang*, 355 F.3d 164, 171-172 (2d Cir. 2004); *In re AmTrust Fin. Servs., Inc. Sec. Litig.*, 2019 WL 4257110, at *11, *17 (S.D.N.Y. Sept. 9, 2019)).

States, however, may have different applicable pleading rules. For example, one New York Commercial Division judge has applied New York's heightened state-law pleading standard for misrepresentation claims to Securities Act claims (see *Matter of Sundial Growers Inc.*, 2020 WL 2543817, at *2 (N.Y. Sup. Ct. May 15, 2020); *Hoffman v. AT&T Inc.*, 2020 WL 2236189, at *2 (N.Y. Sup. Ct. May 6, 2020)), but another Commercial Division judge rejected this approach (see *In re Netshoes Sec. Litig.*, 2020 WL 2893433, at *3-5 (N.Y. Sup. Ct. June 2, 2020)).

Second, Securities Act class actions have increasingly been filed in state courts around the country beyond California, in particular in New York. In 2019, 34 Securities Act class actions were brought outside of California, compared to only six in 2017 and 19 in 2018 (Cornerstone 2019 Review at 19). Filings in New York state courts account for the overwhelming majority of this increase, and in 2019 the number of Securities Act class actions filed in New York (18) surpassed the number of Securities Act class actions filed in California (15) (Cornerstone 2019 Review at 19).

Third, after *Cyan*, defendants in Securities Act class actions face an increased risk of having to manage parallel state and federal litigation or litigation in multiple states. Between 2010 and 2018, there was an average of seven parallel state and federal Securities Act filings per year (Cornerstone 2019 Review at 4). In 2019, 22 of the Securities Act class actions brought in state court had parallel federal filings (Cornerstone 2019 Review at 4). Although the federal courts have a multi-district procedure for handling cases filed in various courts before the same judge, there is no equivalent procedure for cases filed in multiple different states' courts. Likewise, cases in state and federal court cannot be combined.

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Parallel proceedings also cause complexities for all parties because state and federal courts, as further discussed below, sometimes follow different procedural and substantive rules for securities claims.

The collective impact of these 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. As a result, litigants 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.

In addition, litigants should be alert to the effect of parallel proceedings on damages theories. Under Section 11, damages are capped at the difference between the offering price and the stock's value "as of the time such suit was brought" (15 U.S.C. § 77k(e)). Courts have generally measured "the time such suit was brought" to mean the filing date of the initial complaint, not the filing date of amended or subsequent complaints (see *In re Barclays Bank PLC Sec. Litig.*, 2016 WL 3235290, at *5-6 (S.D.N.Y. June 9, 2016); *In re Washington Mut., Inc. Sec., Derivative & ERISA Litig.*, 2010 WL 4272567, at *11 (W.D. Wash. Oct. 12, 2010)). Section 11 damages may thus be limited if the corporation's stock price was higher when an earlier action was filed in a different forum.

For information on key issues surrounding simultaneous investigations, litigations, or enforcement actions arising out of a common set of facts, see Practice Note, Defending Parallel Proceedings: Key Considerations and Best Practices (W-003-8906).

WHAT KEY ISSUES ARE PARTIES AND COURTS FACING IN THE WAKE OF *CYAN*?

Before *Cyan*, many state courts stayed Section 11 cases pending the final resolution of a parallel federal action (Stanford Study at 6, 14). Post-*Cyan*, too, some state courts have granted stays in parallel actions, particularly when the federal suit is commenced first and the state suit is wholly duplicative or unviable (see, for example, *In re Qudian Sec. Litig.*, 2018 WL 6067209, at *2 (N.Y. Sup. Ct. Nov. 14, 2018); *Lowinger v. Solid Biosciences, Inc.*, 2018 WL 3711305, at *2 (Mass. Super. Ct. June 24, 2018)). But state courts are not obligated to grant stays in parallel actions and state courts have denied motions to stay parallel actions, especially when the state suit was filed before the federal suit (see *In Re Dentsply Sirona, Inc.*, 2019 WL 3526142, at *6 (N.Y. Sup. Ct. Aug. 02, 2019)).

Disputes over the degree to which the PSLRA applies to Section 11 claims litigated in state court have also become especially important. Some PSLRA requirements apply to any private action arising under the Securities Act, which defendants argue includes state court actions. Among these requirements is the automatic stay of discovery under 15 U.S.C. § 77z-1(b).

State courts have provided inconsistent answers as to whether this provision applies in state court. The Connecticut Superior Court has found that the PSLRA's use of the phrase "[i]n any private action" suggests that the automatic stay of discovery applies in state courts as well (*City of Livonia Retiree Health & Disability Benefits Plan v. Pitney Bowes Inc.*, 2019 WL 2293924, at *3-4 (Conn. Super. Ct. May 15, 2019)). But state courts in California and Michigan have denied motions to stay discovery finding that state courts are not required to apply the PSLRA's automatic stay provision (*Switzer v. Hambrecht & Co.*, 2018 WL 4704776, at *1 (Cal. Super. Ct. Sept. 19, 2018); *In re Ally Fin. Inc.*, 2018 WL 9596950 (Mich. Cir. Ct. Aug. 1, 2018)). In New York, parties face considerable uncertainty because judges in New York County have issued conflicting rulings on whether the PSLRA's automatic stay applies in state court (compare *In re Everquote, Inc. Sec. Litig.*, 106 N.Y.S.3d 828, 837 (Sup. Ct. 2019) (granting stay of discovery because the text of the PSLRA and the purpose of both the PSLRA and SLUSA support a conclusion that the PSLRA's automatic stay applies in state courts), with *Matter of PPDAI Grp. Sec. Litig.*, 116 N.Y.S.3d 865 (Sup. Ct. 2019) (refusing to grant stay of discovery because applying the PSLRA's automatic stay in state courts would undermine *Cyan*'s holding)).

Even if the PSLRA's automatic stay does not necessarily apply in state court, judges may still exercise their discretion and grant a stay of discovery pending a motion to dismiss (see *In re Greensky, Inc. Sec. Litig.*, 2019 WL 6310525, at *2 (N.Y. Sup. Ct. Nov. 25, 2019) (granting discretionary discovery stay)).

Other provisions of the PSLRA, such as the requirements concerning the appointment of a lead plaintiff and some limitations on damages awards (15 U.S.C. § 77z-1(a)), only apply to actions brought "pursuant to the Federal Rules of Civil Procedure." It remains to be seen whether state courts will apply similar 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.

WHAT RECOMMENDATIONS DO YOU HAVE FOR COUNSEL REPRESENTING CORPORATIONS HOPING TO LIMIT EXPOSURE TO SECURITIES ACT CLAIMS IN STATE COURT?

Corporations should consider a federal forum provision in their articles of incorporation, meaning a forum selection clause specifying that federal court will be the exclusive venue for all Securities Act claims. Notably, the Delaware Supreme Court recently upheld federal-forum provisions in the certificates of incorporation of several Delaware corporations (*Salzberg v. Sciabacucchi*, 227 A.3d 102 (Del. 2020)). Specifically, the Delaware Supreme Court found that federal-forum provisions address "the post-*Cyan* difficulties presented by multi-forum litigation of Securities Act claims" and promote "efficiencies in managing the procedural aspects of securities litigation" (*Salzberg*, 227 A.3d at 114-15, 137). The Delaware Supreme Court's decision may offer a partial solution to the issues created by having to litigate Securities Act cases in state court after *Cyan*.

In addition, 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

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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.

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.

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