The U.S. Supreme Court issued a unanimous decision on March 20 holding that investors are free to file securities class action lawsuits challenging the veracity of stock registration statements under Section 11 of the Securities Act of 1933 in state court. The decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund* increases securities litigation risk for public companies, especially within three years of their initial public offering (IPO) before the statute of limitations expires on challenges to an S-1 registration statement.
This article explains the risks opened up by Cyan. We start with an overview of liability under Section 11, followed by congressional reforms enacted in 1995 to curb abuses in securities class actions and in 1998 to block plaintiffs from evading those reforms, and we explain how many of those reforms are unavailable in state-court Section 11 cases. We conclude with steps that new public companies can take to mitigate their litigation exposure.

1933 Act Liability Under Section 11

The Securities Act of 1933, enacted in the wake of the stock market crash, was designed to curb the wildest days of pre-crash caveat emptor by holding corporate issuers answerable to investors for the veracity of representations about their companies and prospects.\(^1\) Congress enacted a private right of action under Section 11, which holds issuers to a standard of strict-liability for material misstatements and omissions in registration statements that cause losses to investors. Section 11’s low bar for liability makes it relatively easy for investors to rescind or to recover damages based on the difference in value between the securities they bought and their value if the issuer’s registration statement had been materially accurate.\(^2\)

Section 11 liability extends to officers, directors, underwriters, experts and others who sign, prepare or certify all or any part of the registration statement. Defendants other than the issuer itself (which is strictly liable) may escape liability by proving that they did not know, and, in the exercise of reasonable care, could not have known of the material misstatement or omission.\(^3\) In other words, Section 11 exposes non-issuer defendants to liability for damages if they are unable to sustain their burden of proof that they were not negligent.

To mitigate the potentially devastating strict liability exposure to issuers, Congress gave only a narrow group of stockholders standing to sue under Section 11. Standing is limited to those able to plead and prove that they purchased stock that was registered for sale by the particular registration statement that is challenged. Once stock enters the public float from any other sources — such as stock registered in a later secondary public offering or sold after expiration of a management lockup — it becomes part of a “fungible mass” of publicly traded securities, making it nearly impossible for plaintiff investors to establish standing by tracing the shares they purchased to the offending registration statement.\(^4\)
That is why most Section 11 claims are based on stock issued in a company's IPO, when it is still relatively easy for plaintiffs to trace their shares to the initial S-1 registration statement.

When the Securities Act of 1933 was enacted, Congress expressly provided that state and federal courts have concurrent jurisdiction over private actions brought to enforce it, including Section 11, and forbade defendants from removing claims filed in state court to federal court. Thus, investors always had the right to bring Section 11 claims in state court. So why does it matter that Cyan confirmed long standing state court jurisdiction over Section 11 claims?

**Securities Litigation Reform Under the PSLRA**

State court jurisdiction over Section 11 class actions matters now because of strong measures enacted by Congress in 1995 to curb abuses in the filing of securities class actions that made federal courts a much better place for defendants than state courts. The Private Securities Litigation Reform Act of 1995 (PSLRA) raised both procedural and substantive hurdles that plaintiffs must surmount to maintain federal securities class actions, but made the procedural hurdles applicable only through the Federal Rules of Civil Procedure.

In enacting the PSLRA, Congress was concerned that securities strike suits were harming the U.S. economy by subjecting companies, officers and directors to expensive class action discovery and massive theoretical liability exposure, thereby forcing public companies to settle even meritless claims. Congress sought to reduce “abusive practices,” which included “the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer’s stock price, without regard to any underlying culpability . . .”

Congress’s primary focus was on fraud claims filed under Section 10(b) of the 1934 Securities Exchange Act — the mainstay of most private securities class actions. Plaintiffs asserting claims under Section 10(b) must allege and prove that defendants harbored a fraudulent state of mind in making misrepresentations or omissions (or engaging in other manipulations) in connection with the purchase or sale of securities. Following a large drop in a company’s stock price, potential plaintiffs look for public information that may have triggered the decline and then compare that information
against the company’s prior public disclosures, searching for potential misrepresentations and omissions that may have inflated the stock price — a litigation strategy pejoratively dubbed “fraud by hindsight.”

Although Congress mainly was concerned about abuses in securities fraud class actions under Section 10(b), it was cognizant of the same dynamic of potential abuse under Section 11. The PSLRA amended both the 1933 and 1934 Acts to implement hurdles to class action litigation — but, as noted, some of the most robust hurdles apply only in federal court through the Federal Rules of Civil Procedure. This is important because claims under Section 10(b) can only be filed in federal court, which has exclusive jurisdiction, whereas claims under Section 11 could be filed in state or federal court at the plaintiff’s discretion, and, of course, the Federal Rules do not apply in state court.

For example, when a Section 11 claim is filed in federal court pursuant to the Federal Rules, a “lead plaintiff” and “lead counsel” must be appointed based on a motion-and-contest process, restrictions are placed on so-called “professional plaintiffs,” limitations apply to monetary recovery by class representatives, restrictions apply to the amount of attorneys’ fees that may be awarded, and mandatory sanctions apply if plaintiff’s counsel violates Rule 11. Substantive protections in Section 11 cases, available in both state and federal court, include a “safe harbor” for forward-looking statements — but not if the statement was made in connection with an IPO. And the PSLRA limited the liability of outside (non-officer, non-employee) directors to those who “knowingly committed a violation of the securities laws.”


Before the PSLRA, plaintiffs brought most securities fraud litigation in federal court under Section 10(b), rather than in state court under state anti-fraud securities statutes. Plaintiffs found it much easier to obtain nationwide class certification in federal court because federal law obviated the need for proof of individual reliance by recognizing a class wide presumption of reliance on the integrity of the stock price in an efficient market. But after enactment of the PSLRA, state courts became much more attractive to plaintiffs as a way to avoid the heightened pleading requirements for fraud and other defense-friendly reforms in the PSLRA, including the discovery stay pending a motion to dismiss and other hurdles noted above.
Three years after the PSLRA, in 1998, Congress responded to evidence that plaintiffs were flocking to state court and asserting state law securities claims in order to avoid exclusive federal jurisdiction over Section 10(b) claims, which were subject to the PSLRA reforms. Congress enacted the Securities Litigation Uniform Standards Act (SLUSA) to “prevent certain state private securities class action lawsuits alleging fraud from being used to frustrate the objectives of” the PSLRA.\footnote{SLUSA was codified in both the 1933 and 1934 Acts and precluded plaintiffs from maintaining “covered class actions” alleging dishonest practices concerning the purchase or sale of a “covered securities” under state law.} A “covered class action” is brought on behalf of more than 50 investors, and a “covered security” is one traded on a national stock exchange.\footnote{In the years following enactment of SLUSA, a judicial difference of opinion developed nationally over whether ambiguous language in the implementing legislation — described by one Supreme Court Justice as “gibberish” — was intended to repeal concurrent federal and state jurisdiction over 1933 Act claims and force those claims into federal court. California led the nation in finding that concurrent jurisdiction survived SLUSA, and saw a huge uptick in state-court Section 11 filings (leveraged by the Ninth Circuit’s tough stance on pleading standing under Section 11 in federal court). \textit{Cyan} resolved the statutory interpretation argument with a 9-0 vote in favor of an interpretation of SLUSA that does not disturb concurrent jurisdiction over 1933 Act claims. Now that the debate is over, investors are free to file Section 11 claims in state court, thereby avoiding many of the procedural reforms enacted in the PSLRA.} To the extent a plaintiff tries to bring a forbidden state law claim in state court, it is removable to federal court, where it must be dismissed.

There is good reason to expect that plaintiffs will embrace state court venues and that filings in state court under Section 11 following IPOs will increase. The large uptick in state filings in California is a canary in the coal mine for the rest of the country, especially for corporations headquartered in states that are reputed to be friendly to home-court plaintiffs and disinclined to dismiss cases at the pleading stage.

State court venues also offer plaintiff’s lawyers, who compete for control of class actions (and hence the allocation of any settlement fee award), more room to maneuver. There is no risk of consolidation with any parallel federal securities class actions. And there is no state law mechanism for consolidation of duplicative cases comparable to federal multidistrict litigation coordination procedures.\footnote{Corporate defendants inevitably will
face a risk of defending duplicative simultaneous Section 11 cases in multiple forums — in the headquarter state, the state of incorporation, the federal courts in both states, and sometimes in a plaintiff’s home state. We have seen this dynamic before in merger objection class actions where defendants are forced to scramble for discretionary stays in order to avoid parallel multiforum litigation. Primary defense strategies are based on case filing priority, forum non conveniens, comity, “one forum” efficiency, and enforcement of forum selection provisions in corporate charters or bylaws. None of these strategies yields reliably predictable results.

Implications

Newly public companies and IPO hopefuls are not powerless to mitigate state court litigation risk following Cyan. First, pre-IPO companies should consider including a forum selection provision in the articles of incorporation that pre-selects a federal forum for any claims under the 1933 Securities Act. Second, all IPO companies should take care to buy comprehensive director and officer liability insurance coverage that is continuous with respect to pre-and post-IPO conduct. Third, new companies should take note that good professional advisors make all the difference. Fourth, in advance of any public offering of registered stock, the company’s directors, officers and other participants in preparation of the registration statement should attend to preparation of their due diligence defenses. Fifth, all issuers should be vigilant about good disclosure.

Endnotes


4 In re Century Aluminum Co. Sec. Litig., 729 F.3d 1104, 1107 (9th Cir. 2013) (holding that a company that has issued multiple offerings under multiple registration must plead “a greater level of factual specificity . . . before a court can reasonably infer that shares purchased in the aftermarket are traceable to a particular offering.”).


20 15 U.S.C. § 77p(b); see also Cyan, slip op. at 4 ("So taken all in all, § 77p(b) completely disallows (in both state and federal courts) sizable class actions that are founded on state law and allege dishonest practices respecting a nationally traded security's purchase or sale.").

22 15 U.S.C. § 77p(c); Cyan, slip op. at 4 (noting that after removal the “proper course is to dismiss’ the action” (quoting Kircher v. Putnam Funds Trust, 547 U.S. 633, 644 (2006)); see also id. at 5 (“The point of providing [the removal and dismissal] option, everyone here agrees, was to ensure the dismissal of a prohibited state law class action even when a state court ‘would not adequately enforce’ § 77p(b)’s bar.”).


24 Jason Milch & Terri Viera, Securities Class Action Filings Rise to Highest Levels in 20 Years (Jan. 31, 2017) (explaining that there were eighteen Section 11 actions filed in California state court in 2016 and fifteen in 2015, where “[b]efore 2015, these types of state filings occurred infrequently, ranging from one to five per year”), available at https://www.cornerstone.com/Publications/Press-Releases/Securities-Class-Action-Filings-Highest-Level-20-Years; In re Century Aluminum Co. Sec. Litig., 729 F.3d at 1107.


26 P. Palmer, Another Day Another Forum: Strategies for Litigation Class actions and Derivative Suits in Multiple Forums, ABA, Section of Litigation Conference, Chicago 2013, available at https://www.americanbar.org/content/dam/aba/administrative/litigation/materials/sac2013/sac_2013/47_1_ABA_another_day_another_forum.authcheckdam.pdf.