ILR BRIEFLY

COURTING CONFUSION: FEDERAL SECURITIES CLASS ACTIONS DON'T BELONG IN STATE COURTS

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U.S. CHAMBER
Institute for Legal Reform

Courting Confusion: Federal Securities Class Actions Don't Belong in State Courts†

The U.S. securities litigation system is broken, forcing investors to pay hundreds of millions of dollars in unjustified litigation and settlement costs each year—as previous reports by the U.S. Chamber Institute for Legal Reform (ILR) have documented in detail.[1] The very same conditions that led Congress to enact comprehensive securities litigation reform in 1995 are again present, and again imposing significant costs and other burdens on the capital-raising process that is critical to economic growth and the creation of new jobs.

This update focuses on one aspect of this multi-faceted problem: the U.S. Supreme Court's decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*[2] permitting plaintiffs to litigate a significant category of federal securities class action cases—those asserting claims under the Securities Act of 1933 (1933 Act)[3]—in state courts as well as in federal court.

Class actions under the federal securities laws typically involve mammoth claims seeking hundreds of millions or billions of dollars on behalf of thousands of investors. *Cyan* authorizes forum shopping on a broad scale and, most importantly, empowers plaintiffs' lawyers to subject companies to simultaneous litigation on identical claims in federal and state courts. That dynamic multiplies litigation costs dramatically, wasting company, shareholder, and court resources. And those costs ultimately are borne by the investors in companies named as defendants. Congress should close the *Cyan* loophole by enacting legislation requiring 1933 Act claims, like all other federal securities class actions, to be brought only in federal court.

Addressing this abuse of the litigation system is particularly important because the 1933 Act's private cause of action applies to claims based on initial public offering (IPO) documents. IPOs, which make securities available on capital markets, are the principal means by which new companies "go public." This litigation burden targeting IPOs makes raising capital more costly—and therefore makes the public markets less attractive for new companies. That means fewer investment choices for ordinary Americans and less efficient allocation of capital.

Recent developments demonstrate that the abuses enabled by *Cyan*—documented in prior ILR reports[4]—are increasing.

MIGRATION OF CASES TO STATE COURT

In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA),[5] which addressed the problem of abusive securities litigation by, among other measures, imposing heightened pleading requirements, creating restrictions on the selection of lead plaintiffs, and authorizing a stay of discovery pending resolution of any motion to dismiss. In reaction to the PSLRA, plaintiffs' lawyers sought to bring 1933 Act claims in state court—to mixed results: some courts held that Congress had barred the filing of such claims in state court.

The Supreme Court's 2018 decision in *Cyan* resolved that conflict by holding that actions under the 1933 Act may be brought in state court. As a result, there has been a dramatic increase in the number of 1933 Act class actions filed in state court. Since *Cyan* was decided, the level of securities class action filings has been far above historic averages.

ACADEMIC ANALYSIS DEMONSTRATES THAT STATE COURTS PROVIDE A FORUM FOR WEAK 1933 ACT CASES

In the wake of *Cyan*, plaintiffs' lawyers are taking full advantage of state courts' favorable pleading standards and discovery rules to drive up litigation costs with parallel state and federal litigation, and to bring weak claims in state court.

A study by Stanford professors found that between 2011 and 2019, state courts were significantly less likely than federal courts to grant motions to dismiss 1933 Act claims even though the average federal court settlement was more than twice as large as the average state court settlement. Additionally, the fact that the rate of settlement is highest when cases are brought in both state and federal court (instead of one or the other) confirms that costly parallel proceedings increase settlement pressure on companies. In the words of the Stanford study, "[t]he data support these two concerns: Relatively weak cases are filed in state court, and parallel litigation in state and federal court has become common and appears to pressure defendants to settle."[6]

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DUPLICATIVE LITIGATION IN STATE AND FEDERAL COURTS

Another very significant problem resulting from *Cyan* is that companies can be—and frequently are—subjected to multiple 1933 Act class action lawsuits in state and federal courts filed by different plaintiffs but asserting essentially identical claims. As a commentator has noted, "there is nothing to stop plaintiffs' lawyers from filing a duplicate lawsuit."[7] When multiple claims are filed in federal court, they can be, and are, consolidated to avoid compounding litigation defense costs; but there is no similar mechanism for coordinating claims filed in state and federal court or in different state courts. And the problem is widespread: the Stanford study found that, post-*Cyan*, approximately half of all 1933 Act class actions involve this duplicative litigation.[8]

FORUM-SELECTION CLAUSES NOT YET A LIKELY SILVER BULLET

The Delaware Supreme Court recently held that companies incorporated in Delaware may include in their bylaws a provision requiring that 1933 Act claims be brought in federal court, and several trial courts in other states have favorably cited that decision. Although that is a positive development, it will not eliminate the inefficiencies created by allowing state courts to hear 1933 Act cases. It is not clear whether Delaware courts will enforce forum-selection provisions in all circumstances, and there is no guarantee that other states will honor such provisions. Furthermore, the decision does not help companies incorporated in other states or foreign corporations.

CONGRESS SHOULD ACT

Targeted statutory changes to fix the problem created by *Cyan* would ensure that 1933 Act claims must be brought in federal court, just like all other securities actions.

Recently, the Supreme Court granted review of a certiorari petition presenting the question of whether the PSLRA's discovery protections apply to cases in state court, an issue on which the lower courts have reached conflicting conclusions.[9] If the Court rules that the protections apply—a big "if" given the decision in *Cyan*—that may limit the attraction of state court. But if the Court holds that the protections do not apply, then state courts will become an even more attractive forum, because plaintiffs' lawyers will be able to avoid the law's anti-abuse protections.

"When multiple claims are filed in federal court, they can be, and are, consolidated to avoid compounding litigation defense costs; but there is no similar mechanism for coordinating claims filed in state and federal court or in different state courts."

Class Actions Targeting IPOs Remain at Historically High Levels

Recent years have seen a marked increase in securities class action filings, and that trend continued in 2020. Each of the studies tracking such filings found that 2020 saw a level of litigation far above historic averages. Although filings were below the record-setting levels seen between 2017 and 2019, that was likely due to the COVID-19 pandemic, which caused a reduction in merger activity.[10] As one experienced observer of securities litigation explained, "the second quarter filing lull looked as if it might be attributable to the coronavirus outbreak," and a lull later in the year "may be attributable to the pandemic's second wave."[11]

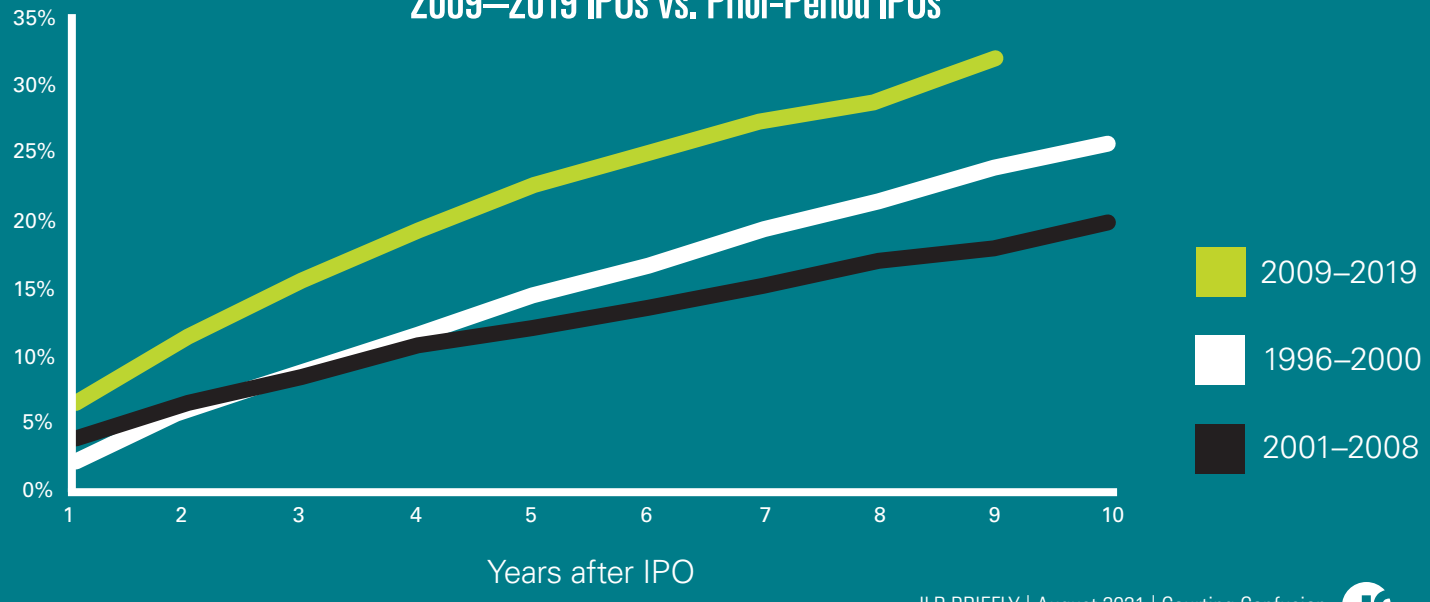
In addition, the current very strong stock market deters lawsuits, because plaintiffs' lawyers need a significant price drop to create a sufficiently-large damages claim.[12] Securities suits filed as class actions also declined in the first half of 2021, but the number of filings was only slightly below the semiannual average from 1997-2020.[13]

> *"Importantly, the size of 2020 cases—although short of 2018's record—remains very large by historical standards."*

Importantly, the size of 2020 cases—although short of 2018's record—remains very large by historical standards. Analysts measure the relative size of a case by examining the dollar-value change in a defendant company's outstanding shares before and after the class period. The $245 billion calculated for 2020's cases is significantly higher than the 1997-2019 average of $136 billion.[14] Likewise, total settlement dollars[15] and median settlement value[16] of securities class actions continued to outpace the ten-year average.

These trends apply to 1933 Act claims, which target IPOs. These lawsuits too, remained at historically high levels notwithstanding a decline in both IPO and lawsuit activity due to COVID-19.[17]

Likelihood of Litigation Against Recent IPOs—Core Filings 2009–2019 IPOs vs. Prior-Period IPOs[18]



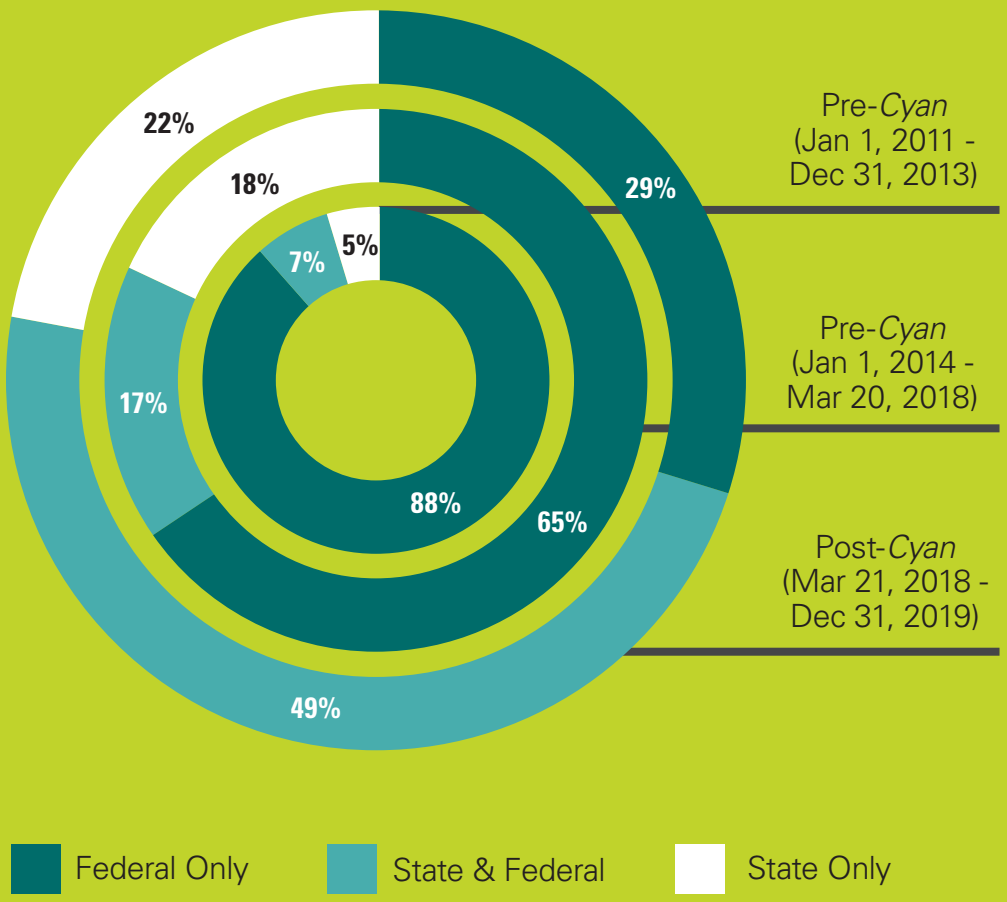
Even more important, the likelihood that an IPO will be subject to litigation has doubled. IPOs between 2009 and 2019 had an approximately 1-in-5 chance of being subject to a class action within four years—nearly twice the likelihood that an IPO between 2001 and 2008 attracted a lawsuit within that same period.[19] This reality means that potential investors must factor in the cost of litigation—which runs into the millions of dollars—when determining whether to fund a new business. And that risk is a major reason for the significant premium hikes in IPO companies' D&O insurance, which remains at record levels.[20]

State Courts Provide a Safe Harbor For Unjustified 1933 Act Claims

THE POST-*CYAN* SHIFT TO STATE COURT

The consequences of the Supreme Court's *Cyan* decision are now fully realized. Although the number of 1933 Act class actions filed in state court in 2020 reflected a decrease from 2019—again, a result of the COVID-19 effect—the 2020 filings still were nearly double the average for state court filings from the eight years preceding the *Cyan* decision.[21] It is not surprising that the Stanford study's analysis of 1933 Act filings concludes that state court filings have "skyrocketed" since *Cyan* was decided.

Forum Mix in Securities Act Cases Filed 2011 Through 2019[22]



A report from a consulting firm documents that same litigation shift. The report found that in 2010-2012, 82 percent of the IPOs targeted by 1933 Act claims faced suits only in federal court; 6 percent were sued only in state court; and 12 percent faced claims in both state and federal courts.[23] By 2018-2020, there was a dramatic shift: only 29 percent of IPOs were sued only in federal court; 34 percent were sued only in state court; and 37 percent were sued in both courts.[24]

As one securities analyst explained, the *Cyan* loophole "increases the likelihood that a company defendant might have to fight a multi-front war" and "IPO companies now face a measurably more significant risk of getting hit with a securities lawsuit than may have been the case before *Cyan*."[25]

> *"[T]he* Cyan *loophole 'increases the likelihood that a company defendant might have to fight a multi-front war' and 'IPO companies now face a measurably more significant risk of getting hit with a securities lawsuit than may have been the case before* Cyan.*'"*

STATE COURTS HAVE FEWER PROTECTIONS AGAINST ABUSIVE LAWSUITS

The dramatic increase in 1933 Act class actions filed in state court is driven by the fact that state courts offer more favorable forums to plaintiffs than federal courts for litigating securities claims. They generally lack experience with federal securities law and have plaintiff-friendly procedural rules that force companies to settle even meritless claims—in contrast to the PSLRA's anti-abuse protections that apply in federal court but typically are not observed in state court.

First, the pleading standard governing motions to dismiss is typically more lenient in state court, which allows weaker cases to survive dismissal motions. The bulk of 1933 Act state court class actions are filed in California and New York[26]—and both jurisdictions have pleading standards more lenient than the federal standard.[27]

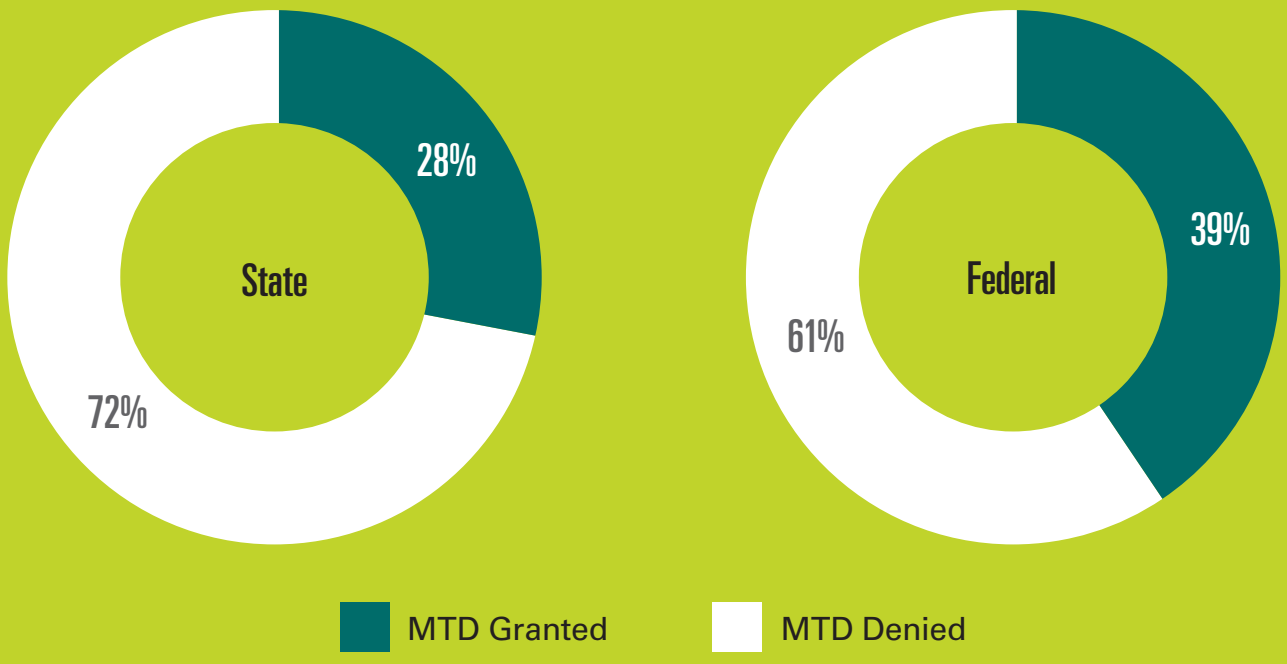
Additionally, the timing of discovery in relation to a ruling on a motion to dismiss draws 1933 Act class actions to state court. In federal courts, the PSLRA automatically stays discovery during the pendency of a motion to dismiss a 1933 Act suit. That prevents plaintiffs' lawyers from filing barebones complaints in the hope that discovery will turn up incriminating evidence. By contrast, state courts generally permit discovery to begin before ruling on a motion to dismiss.[28] Early discovery before a motion to dismiss is even decided imposes significant costs on defendants and creates pressure to settle—even if there is little risk that the discovery process will lead to a plausible cause of action.[29]

WEAK CLAIMS DO WELL IN STATE COURTS

The Stanford study finds that even though state courts attract weaker 1933 Act cases, motions to dismiss those cases nonetheless are granted 28 percent of the time, compared to a dismissal rate in federal court of 39 percent.[30]

Additionally, the financial cost and litigation risk imposed by state court discovery rules create a strong incentive for defendants to settle weak claims. The Stanford study confirms that state courts attract weaker claims, finding that the average federal court settlement of a 1933 Act claim between 2011 and 2019 was more than twice as large as the average state court settlement as a percentage of awardable damages.[31] The fact that state court cases settle for a smaller portion of potential damages indicates that the parties view the claims to be weaker, on average, than those asserted in federal court.

Rulings on Motions to Dismiss in Cases Filed 2011 Through 2019[32]



Evidence from that same period also confirms that litigating parallel state and federal proceedings increases settlement pressure on companies. Duplicative lawsuits by different lawyers in state and federal courts force companies to defend the same claim at the same time in multiple forums—multiplying the cost of litigation, which ultimately is borne by shareholders. Thus, whereas the settlement rates for cases filed only in state court and only in federal court is 67 percent and 65 percent, respectively, the settlement rate for 1933 Act cases with parallel proceedings in both state and federal court is 82 percent.[33]

The bottom line is that plaintiffs' lawyers with weak claims have a better chance of success in state court—which is why an increasing number of claims are filed there. And plaintiffs' lawyers can increase their settlement leverage when multiple claims are filed in state and federal courts.

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Duplicative Proceedings in Federal and State Courts Multiply the Economic Burden on Investors

As alluded to above, the problems associated with the filing of these federal class actions in state court are compounded by the fact that many IPOs are the subject of lawsuits in both federal and state courts. For example, in 2019, 25 IPOs faced lawsuits in both state and federal court—and some in multiple state courts.[34]

Unlike duplicative claims in federal courts (which can be consolidated even if filed in different parts of the country), duplicative cases filed in multiple state courts and duplicative cases filed in state and federal courts cannot be consolidated, so companies incur duplicative costs litigating the same case before different courts. Indeed, state courts often deny motions to stay proceedings pending resolution of a parallel federal case.[35] The *Cyan* loophole thus "increases the likelihood that a company defendant might have to fight a multi-front war."[36]

For plaintiffs' lawyers, these duplicative proceedings are a welcome feature, not a bug. As the Stanford study put it, "parallel litigation in state and federal court has become common and appears to pressure defendants to settle."[37]

> *Indeed, state courts often deny motions to stay proceedings pending resolution of a parallel federal case.*

Forum-Selection Clauses Will Likely Not Eliminate the Problem

Recognizing the risks of parallel 1933 Act litigation in state and federal court, the Delaware Supreme Court has held that companies incorporated in Delaware may include in their bylaws a provision requiring that 1933 Act claims be brought in federal court.[38] With that ruling, Delaware corporations now can seek to use forum-selection provisions to protect themselves against the burdens of simultaneously defending such lawsuits in federal court and state court. However, the Court held only that such provisions are facially valid, and expressly noted that the "question of enforceability is a separate, subsequent analysis."[39] That leaves open the possibility that Delaware courts may not enforce forum-selection provisions in all, or even most, circumstances.

Notably, several California trial courts have cited the Delaware Supreme Court's decision in dismissing 1933 Act claims against Delaware corporations whose bylaws or charters contain federal forum-selection provisions.[40] However, even if those orders ultimately are upheld, they apply only to the bylaws or charters of specific companies incorporated in Delaware and sued in California.

These recent decisions do nothing to help companies incorporated in other states (unless those states also permit forum-selection provisions) or foreign corporations. Nor are the decisions any guarantee that when Delaware corporations are sued in other states, those courts will honor forum-selection provisions. Indeed, the possibility that states will develop different rules with respect to the validity of such provisions further exacerbates the problem for companies, which are forced to navigate the rules of multiple jurisdictions in order to defend against federal securities claims.

As the authors of the Stanford study conclude, the potential validity of some forum-selection provisions, although a positive development, will not "eliminate the inefficiency created by allowing state courts to hear" 1933 Act cases.[41]

> *"[T]he potential validity of some forum-selection provisions, although a positive development, will not 'eliminate the inefficiency created by allowing state courts to hear' 1933 Act cases."*

Congressional Action is Needed

Congress should enact targeted statutory changes to ensure that 1933 Act claims are heard in federal court, as is true of all other securities actions. There are two ways that Congress could fix the problem created by *Cyan*.

First, Congress could simply close the *Cyan* loophole by requiring that all 1933 Act claims be brought in federal court. That would eliminate the inconsistency between the 1933 Act and the Securities Exchange Act of 1934, which governs securities trading.

Second, Congress could authorize the removal of 1933 Act class actions to federal court. That would provide defendants with a tool to eliminate parallel cases in federal and state court, and to consolidate all related class actions into a single proceeding (the United States filed an amicus brief in *Cyan* urging the Court to hold that 1933 Act class actions were removable under the Securities Litigation Uniform Standards Act of 1998 (SLUSA), but the Court rejected that argument.[42])

Those reforms will not deprive any plaintiff of his or her day in court—or change the rules governing their claims. They will simply eliminate the possibility of unfair forum shopping and will ensure that companies, and their shareholders, are not forced to bear the unjustified and unfair costs of defending against multiple lawsuits. Such reforms would also safeguard limited judicial resources from duplicative litigation.

Endnotes

† This edition of *ILR Briefly* was prepared by Andrew J. Pincus and Avi Kupfer, Mayer Brown LLP.

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10 Cornerstone Research, *Securities Class Action Filings – 2020 Year in Review* 1, 6, 23 (2021), https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2020-Year-in-Review.

11 Kevin LaCroix, *Securities Suit Filings Declined in 2020 But Remained Above Historical Levels,* D&O Diary (Jan. 3, 2021), https://www.dandodiary.com/2021/01/articles/securities-litigation/securities-suit-filings-declined-in-2020-but-remained-above-historical-levels/.

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28 Klausner et al., *supra,* at 1773.

29 As explained, the Supreme Court has granted review to decide whether the PSLRA's discovery-stay provision must be applied by state courts.

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31 *Id.* at 1781.

32 Klausner et al., *supra,* at 1777.

33 *Id.* at 1783.

34 Cornerstone Research, *supra,* at 21.

35 Klausner et al., *supra,* at 1785-88.

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37 Klausner et al., *supra.*

38 *Salzberg v. Sciabacucchi,* 227 A.3d 102 (Del. 2020).

39 *Id.* at 134.

40 *In re: Sonim Techs., Inc., Sec. Litig.,* No. 19-CIV-05564 (Cal. Super. Ct. Dec. 7, 2020); *In re: Dropbox, Inc. Sec. Litig.,* No. 19-CIV-05089 (Cal. Super. Ct. Dec. 4, 2020); *In re Uber Techs., Inc., Sec. Litig.,* No. CGC-19-579544 (Cal. Super. Ct. Nov. 16, 2020); *Wong v. Restoration Robotics Inc.,* No. 18-CIV-02609, 2020 Cal. Super. LEXIS 227 (Cal. Super. Ct. Sept. 1, 2020).

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