OLD REPUBLIC PROFESSIONAL

Issue 107 November 2016

OldRepublicPro.Comments

A Newsletter from Old Republic Professional

Underwriters of D&O and Professional Liability Insurance

In this issue … *Should state courts or federal courts hear securities class action lawsuits alleging violations of the Securities Act of 1933 ('33 Act)? That question has been submitted to the United States Supreme Court, which is now deciding whether to accept the case for resolution.*

FORUM DEADLOCK: WHERE SHOULD SECURITIES CLASS ACTION LAWSUITS BE HEARD?

Background

In 1995, the federal Private Securities Litigation Reform Act (PSLRA) was enacted to eliminate perceived abuses by plaintiffs in the way they litigated federal securities class action lawsuits. But because the PSLRA provisions only apply to lawsuits filed in the federal courts, some resourceful plaintiffs' attorneys responded to the PSLRA by filing some securities class actions in state court. At that time, the Securities Exchange Act of 1934 ('34 Act) required all claims under the '34 Act (including Section 10(b) "open market" claims) to be filed in federal courts, but the '33 Act permitted plaintiffs to file claims under that statute (including Section 11 claims for misrepresentations in an IPO or secondary offering) in either federal or state courts.

Congress reacted to that plaintiff tactic by enacting the Securities Litigation Uniform Standards Act (SLUSA) three years after the enactment of the PSLRA. As stated in a joint Senate and House committee report describing that new legislation:

> *The purpose [of SLUSA] is to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court … . Additionally … [SLUSA] establishes uniform national rules for securities class action litigation involving our national capital markets.*

Pursuant to SLUSA, all federal securities class action lawsuits under either the '33 Act or the '34 Act must be litigated in federal court. But, SLUSA also contains a potentially ambiguous provision relating to the removal of state securities claims to federal courts. That provision has spawned disagreements among courts as to the propriety of litigating '33 Act claims in state court, despite the seemingly clear intent of SLUSA to prevent that result. That issue has received increased judicial scrutiny in the last few years as IPO-related securities litigation has increased.

Following the enactment of SLUSA, some plaintiffs continue to file their ’33 Act claims in state court, and defendants respond by removing those claims to federal court. Plaintiffs frequently then request the federal court to remand the claims back to state court. Most federal courts throughout the country refuse to remand those cases back to state court based on SLUSA.

But recently, a number of federal courts in California have remanded these cases back to state court. Defendants have then sought dismissal based on lack of state court jurisdiction, but California state courts have been quite reluctant to dismiss those cases. As a result, defendants in IPO securities litigation in California are now forced to defend those cases in state courts, whereas IPO securities litigation in other states are almost always litigated in federal courts consistent with SLUSA.

In one such California case, defendants are now trying to convince the U.S. Supreme Court to resolve the question of whether ’33 Act securities class actions should only be litigated in federal courts or whether plaintiffs can elect to litigate those cases in state courts, notwithstanding SLUSA. In *Cyan, Inc. v. Beaver County Employees Retirement Fund, et al.*, the petitioners cite several factors in support of their position that these cases should be litigated only in federal court: the original intent of SLUSA was to stop plaintiffs from circumventing the PSLRA through state court litigation; the dramatic spike in ‘33 Act cases brought in California state courts, which is now viewed by plaintiffs throughout the country as the preferred forum for IPO securities litigation; the fact that defendants can face parallel securities class action lawsuits in state and federal court if plaintiffs’ tactics are upheld; and the split between different federal courts on the issue. According to the petitioners, the current inconsistency between courts on this issue creates chaos rather than the uniformity intended by SLUSA (*n.b.,* the Securities Litigation *Uniform* Standards Act).

State or Federal: Why does it matter so much?

Federal courts are generally viewed as the preferred forum for defendants. As noted above, the 1995 PSLRA created federal securities class action lawsuit procedures which were intended to curb abusive litigation practices by the plaintiffs’ bar. For example, serial plaintiffs are required to reveal their participation in similar lawsuits during the past three years; plaintiffs (not just the plaintiffs’ lawyers) must confirm they actually reviewed and approved the complaint in the lawsuit; a limited “safe harbor” against liability for forward-looking statements was created; new and more rigorous pleading standards were enacted; and the expensive discovery process is suspended until a motion to dismiss the case has been decided by the court.

However —and critically— state courts need not, and generally do not, apply the provisions of the PSLRA. According to a brief filed by a group of law professors in support of the U.S. Supreme Court petition, this dichotomy between how securities class actions are litigated in federal and state courts defeats the purpose of SLUSA and deprives the more experienced federal courts from creating more uniform substantive case law in this area.

In addition, according to the lead attorney for the petitioners to the U.S. Supreme Court, the current jurisdictional “chaos” will have a detrimental effect on business creation and capital raising: “Our state [California] is an IPO factory…and when the price dips from its IPO price you can get sued in state court.… Federal judges are pretty good about throwing out suits that don’t have merit,” implicitly suggesting that frivolous and weak cases stand a better chance of surviving in the state court system.

Another problem with the current situation in California is that defendants in state court ’33 Act lawsuits will very likely be forced to defend two or more sets of lawsuits arising out of the same alleged wrongdoing: one or more state court lawsuits under the ’33 Act, and a federal court lawsuit under the ’34 Act (which everyone agrees must be litigated in federal court). These parallel suits create judicial inefficiency, increased costs to the defendants and the risk of inconsistent court rulings on essentially the same issues.

Likelihood of U.S. Supreme Court Relief

This type of appeal to the U.S. Supreme Court is not automatic. Instead, the petitioners must first ask the Court to accept the appeal and hear the case, which is the current status of the *Cyan* case. Petitioners have filed their writ of certiorari, explaining why the case is important and should be accepted by the Court. Respondents have filed an opposing brief, contending the Court should not hear the case.

Other interested observers have also filed briefs in support of the petition. Besides the group of law school professors referenced above, the Securities and Financial Markets Association, the Chamber of Commerce of the United States, and the National Venture Capital Association filed a joint brief urging the Court to accept the case, arguing: “If left unchecked, the proliferation of ’33 Act class action lawsuits in state courts will have severe consequences for the nation’s capital markets.”

According to the U.S. Supreme Court’s web site, the Court receives more than 6,000 petitions for a writ of certiorari each term, but it accepts only about 80 of those cases for decision (i.e., just over 1%). The *Cyan* petitioners received some promising news on October 3, 2016, when the Court announced it referred the *Cyan* writ of certiorari to the U.S. Solicitor General for a recommendation on whether the case was sufficiently important that the Court should accept the case for a ruling. This development suggests that at least some justices recognize the potential importance of the case from a macro perspective, beyond the impact to the parties in this case. Frequently, when the U.S. Supreme Court requests the recommendation of the Solicitor General, the Court follows that recommendation.

Whether the U.S. Supreme Court will ultimately accept this case is far from clear. One of the Court’s main roles is to resolve inconsistencies in the lower courts, and there appears to be plenty of that in this case. The Court also interprets acts of Congress, and that function is present here as well. However, the Court usually prefers to address disputes that are of national importance and implication. The Court may view the *Cyan* petition as concerning too small a universe of dispute. Notwithstanding the purported specter of wide economic ramifications as described by the petition’s supporters, the reality might be less dramatic and mostly confined to northern California.

There is no question that companies issuing securities in California and their D&O insurers are significantly and directly impacted by the issue. The rise in the number of ’33 Act filings in California state court has created significant extra defense costs, settlement costs and liability exposure for those companies and their D&Os. Much of this cost is being borne by the insurance carriers.

The U.S. Supreme Court will likely decide whether to accept the case sometime in the first quarter of 2017. If the writ of certiorari is granted, then the parties will brief and argue to the Court the substantive merits of the appeal, with a ruling likely in the summer of 2017. Much is at stake for many different constituencies, so the case will be closely watched and potentially could become one of the most important securities law cases in many years.

We would like to thank Dan A. Bailey, Member, Bailey Cavalieri LLC, for his help with writing this newsletter.

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