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The impact of *Cyan* on public companies and the D&O insurance marketplace

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MAY 10, 2018

Blue Apron, the "meal kit" service that delivers prepackaged ingredients and recipes to its customers, went public June 29, 2017, offering 30 million common stock shares on the New York Stock Exchange. By most accounts, its initial public offering grossly underperformed, as its share price fell substantially in the months after it began trading.

In late March 2018, Blue Apron was trading at less than $2 per share, an 80 percent drop from its initial trading price of $10 per share. Predictably, Blue Apron has been hit with multiple securities class action lawsuits alleging that it failed to adequately disclose material information. Among the allegations are claims that Blue Apron violated federal securities laws, including the Securities Act of 1933.

Securities class actions like these are oftentimes expensive to litigate, and they can lead to significant losses for the companies involved. The U.S. Supreme Court's recent decision in *Cyan Inc. v. Beaver County Employees Retirement Fund* is likely to have a significant impact on the targets of these suits — and by extension, their insurers.[1]

In *Cyan*, the high court reaffirmed that state courts have concurrent jurisdiction with federal courts to adjudicate securities class actions brought under the '33 Act. This expert analysis examines the court's rationale in *Cyan*, the impact the ruling is likely to have on securities class actions, and the potential alternatives to litigating a '33 Act case in state court. It also considers the implications of *Cyan* for directors-and-officers insurance providers.

JURISDICTION FOR SECURITIES LAW CASES

Two federal statutes serve as the framework for governing the sale of securities. The '33 Act regulates the offering of new securities to the public and requires "full and fair disclosure" of relevant information, while the Securities Exchange Act of 1934 regulates the trading of existing securities on securities exchanges.

Congress authorized state and federal courts to have concurrent jurisdiction over suits brought pursuant to the '33 Act. In addition, the '33 Act barred the removal of such actions from state to federal court. The '34 Act, by contrast, grants federal courts exclusive jurisdiction to hear private suits brought under that statute.

Congress passed the Private Securities Litigation Reform Act in 1995 to limit "perceived abuses of the class-action vehicle" in securities cases.[2] The PSLRA created procedural hurdles to securities class actions filed in federal court.

It also had the unintended consequence of funneling more securities cases to state court. This prompted Congress to act again by passing the Securities Litigation Uniform Standards Act of 1998.

Two provisions of SLUSA limiting the jurisdiction of state courts over '33 Act cases are relevant to *Cyan*.

> The Supreme Court in *Cyan* held that SLUSA does not permit defendants to remove class actions alleging only '33 Act claims from state to federal court.

First, Section 77p(b) says "covered class actions" (meaning a class action involving more than 50 people) based on alleged violations of state law involving dishonest practices regarding a nationally traded security's purchase or sale may not be brought in any state or federal court.

Second, Section 77p(c) provides for the removal of "covered class actions" to federal court so that they can be subject to dismissal based on the bar on state law class actions set forth in paragraph (b).

As the Supreme Court noted in *Cyan*, the point of providing for removal of class actions under paragraph (c) was to "ensure the dismissal of a prohibited state law class action" even where the action was initially brought in state court.[3]

SUPREME COURT'S *CYAN* DECISION

Cyan was initially filed in California state court by a class of investors who purchased shares of Cyan, a telecommunications company, in an IPO. The investors alleged that Cyan's offering materials contained material misstatements in violation of the '33 Act.

Critically, there were no state law claims alleged in *Cyan*. Instead, all claims in the case were raised under the '33 Act.

The defendants in *Cyan* sought to have the case dismissed, arguing that SLUSA's amendments to the '33 Act stripped state courts of the authority to adjudicate '33 Act claims in "covered class actions."

Eventually, the Supreme Court granted review of the case and rejected the defendants' argument, holding that SLUSA leaves intact the concurrent jurisdiction of state and federal courts to adjudicate '33 Act claims.

At issue in *Cyan* was a "conforming amendment" to the '33 Act that was part of SLUSA. The conforming amendment was drafted as an "exception" to the general rule that authorizes concurrent jurisdiction of '33 Act suits in state and federal court, and provides that state and federal courts have concurrent jurisdiction over '33 Act class actions "except as provided in Section 77p." This is referred to in the decision as the "except clause."

Cyan hands the plaintiffs' bar the tactical advantage of being able to choose which forum would be most advantageous for them.

As explained above, Section 77p prohibits class actions involving more than 50 people based on alleged violations of state law, and permits removal of such actions to federal court in order to ensure that the state law class action bar is enforced.

The Supreme Court unanimously held that the except clause does not apply to securities class actions brought solely under federal law because Section 77p only prohibits suits based on state law. Therefore, since the "except clause" does not apply, the general "background" rule permitting concurrent jurisdiction of '33 Act securities class actions governs.

In addition, the Supreme Court in *Cyan* held that SLUSA does not permit defendants to remove class actions alleging only '33 Act claims from state to federal court. The '33 Act expressly prohibits removal of such actions from state to federal court. Again, the Supreme Court interpreted SLUSA as only allowing removal of proposed securities class actions based on state law.

THE POTENTIAL IMPACT

The obvious and most immediate impact of the court's decision is that the plaintiffs' bar will likely file additional '33 Act cases in state court. This could allow plaintiffs to avoid the procedural hurdles for securities class actions in the PSLRA.

One example noted in *Cyan* is the rule that requires a lead plaintiff in any class action brought under the Federal Rules of Civil Procedure to file a sworn certification stating that he had not purchased the security at issue "at the direction of plaintiff's counsel."[4] Such procedural rules obviously would not apply to securities class actions filed in state court. *Cyan* hands the plaintiffs' bar the tactical advantage of being able to choose which forum would be most advantageous for their clients.

California state courts are a favorite venue of plaintiffs' attorneys partly because they are less vulnerable to dismissal motions there than they are in federal court. According to Cornerstone Research, California state courts dismissed '33 Act claims at a lower rate between 2010 and 2016 (19 percent) than their federal court counterparts (25 percent).

It should be noted that the holding in *Cyan* does not affect '34 Act cases, which involve regulation of securities already trading in the marketplace, because federal courts have exclusive jurisdiction over those cases.

As a result, we could see parallel lawsuits filed in state and federal court in cases where violations of both the '33 Act and '34 Act are alleged, with federal courts adjudicating the '34 Act claims and state courts adjudicating the '33 Act claims. The obvious result of this would be a likelihood of duplicative litigation and an increase in defense costs.

ALTERNATIVES TO REMOVAL

As stated above, SLUSA did not impact the '33 Act's bar on removal of securities class actions brought under the '33 Act from state to federal court. As such, defendants in such cases cannot use either federal question jurisdiction or diversity jurisdiction to remove an action that solely alleges violations of the '33 Act.

There are alternatives, however, that companies may wish to consider.

First, they can adopt bylaws or provisions in their corporate charter designating federal court as the exclusive forum for litigating '33 Act cases. Such forum-selection clauses are the subject of a lawsuit against Blue Apron, Roku and Stitch that is currently pending in Delaware Chancery Court.[5] All three companies included a provision in their certificates of incorporation that says any claim under the '33 Act must be brought in federal court.

The plaintiff in the lawsuit, which was filed as a putative class action on behalf of shareholders of the three companies, is seeking a declaratory judgment that the forum-selection clauses in the corporate charters are invalid under Delaware law.

Of course, if the Chancery Court strikes down these clauses, they will no longer be a viable option for companies seeking to keep '33 Act cases in federal court.

Second, defendants could seek to transfer the case under the doctrine of forum non conveniens. Under this doctrine, courts apply a variety of factors to decide whether to transfer a case to a different court.

These factors include the convenience of the parties and witnesses as well as the strength of the two venues' citizens' interests in the case. There is more uncertainty associated with this option compared to removal, since dismissal based upon forum non conveniens is a matter of the court's discretion.

Third, in matters involving parallel state and federal court litigation, the defendants could seek a stay of the state court case pending the outcome of the federal court case. Again, this decision is left up to the court's discretion.

Of course, as noted above, the ban on removal for '33 Act cases might not apply where a lawsuit alleges some other basis of federal question jurisdiction.

For example, claims brought under the '34 Act would be subject to removal or dismissal for lack of subject matter jurisdiction. Another possible basis for invoking federal question jurisdiction is the existence of a pending federal bankruptcy proceeding.

Finally, *Cyan* could prompt Congress to overturn the Supreme Court's holding by amending SLUSA to expressly bar state-court jurisdiction over '33 Act claims, either for securities class actions or individual shareholder suits — or both.

IMPLICATIONS FOR D&O INSURERS

If '33 Act cases filed in state court gain traction with the plaintiffs' bar, one potential downside for businesses is a decrease in the ability to obtain dismissal at an early stage in the litigation. As explained above, some state courts, such as those in California, dismiss cases at a lower rate than their federal counterparts.

If more '33 Act cases survive the motion to dismiss stage, defense costs will increase substantially. Faced with the prospect of lengthy, expensive litigation, businesses might consider settling these lawsuits at an earlier stage simply to avoid incurring significant defense costs.

In the face of such trends, D&O insurers should remain proactive in the claims-handling process.

First, they should actively engage with defense counsel to explore avenues for early resolution of such cases in order to minimize the impact on both the insureds and the insurers. While the insureds under D&O policies often control the defense of '33 Act and other securities lawsuits, it is important for D&O insurers to freely discuss strategy with the insureds and have their views heard.

Second, in light of the decision in *Cyan*, D&O insurers should continue to regularly monitor the progress of '33 Act cases from inception through conclusion and share their experiences internally with both underwriting and claims. This will provide valuable insight into how, and if, the *Cyan* decision is impacting the expenses and severity associated with '33 Act cases filed in state court.

Third, D&O insurers should adhere to the basics of carefully reviewing their policies for provisions that grant or exclude coverage for '33 Act claims, and when appropriate, consult with coverage counsel who may have broader experience with the trends developing in this area.

Finally, it is always in the best interest of insurers (and their insureds) to proactively monitor claim trends and collaboratively develop strategies to counter the efforts of the plaintiffs' bar.

NOTES

1 138 S. Ct. 1061 (2018).

2 *Id.* at 1066.

3 *Id.* at 1068.

4 *Id.* at 1067.

5 *Sciabacucchi v. Salzberg,* No. 2018-0931, *complaint filed,* 2017 WL 6815531 (Del. Ch. Dec. 29, 2017).

This article first appeared in the May 10, 2018, edition of Westlaw Journal Securities.

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