Time To Resolve Post-Cyan Securities Class Action Confusion

By **Nessim Mezrahi**

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The Supreme Court decision in Cyan Inc. v. Beaver County Employees Retirement Fund "swings the doors of state courts wide open to actions asserting '33 Act claims against issuers, officers, directors, underwriters, and others involved in the securities offering process."[1] The decision has birthed ramifications that deepen the knowledge gap between business entrepreneurs that aim to take a company public in the U.S., and the professionals that will work to protect them once the bell rings.

According to a June 18, 2019, article titled "D&O Insurance Costs Soar as Investors Run to Court Over IPOs," the premiums that corporations incur to protect their directors and officers against alleged violations of the Securities Act of 1933 have "increased as much as 200% in the last three years."[2] Securities Act claims that are litigated in a state forum inhibit transparency in the securities class action arena. There are well-documented effects of Cyan that are contributing to global skepticism of the "American-style entrepreneurial litigation" system.[3]

Accessing state claims data and information resembles Wall Street "80 years ago – [when] the street was filled with dozens of young men — 'runners' — carrying paper back and forth."[4] If state courts are in fact an adequate venue to litigate Securities Act claims that affect global investors in U.S. capital markets, then "[w]e need to bring both rigor and transparency to this process to give businesses, investors, and the public a clear sense of the rules of road."[4] No such clarity exists within the mist that Cyan has created. Congressional intervention is now duly warranted to clear the fog and provide guidance to business leaders and their investors that aim to bring companies public in U.S. capital markets at the height of the digital revolution.[5]

The ongoing parallel Securities Act claims against Snap Inc. epitomize Cyan's judicial complexity.[6] The type of complex legal maneuvering that is exhibited in this case does not foster a fertile business environment for growth and innovation. Instead, it seeds fear among entrepreneurs — and their investors — that sweat it out to successfully take a company public in the U.S. capital markets. Cyan is slowly clouding the value of old-fashioned sweat equity. There are well-documented issues with this legal decision that severely undermine the harmony that exists between healthy entrepreneurial litigation and effective fraud deterrence.

Parallel state claims for alleged violations of the Securities Act place undue strain on the judicial system and devalue the efficacy of the class action mechanism in the U.S. For example, the approval of a proposed lead plaintiff in a state claim may require individualized inquiry from proposed class members in a parallel federal claim. Any requirement of individualized inquiry in either of the proposed federal or state classes of allegedly defrauded investors will render them uncertifiable. "Carving out" a subclass in a state claim to avoid individualized inquiry in the parallel federal claim would lead to "[f]ractured class actions [that] not only waste judicial resources and unduly burden defendants, but can harm absent class members as well."[7]

The well-established methodology for estimating aggregate damages in securities class actions that allege violations of Section 11 of the Securities Act is straightforward. Maximum recoverable damages for a proposed class of allegedly defrauded investors are equal to the difference between the purchase price at the initial public offering (or secondary public offering) and the price when the class action was filed.[8] With Cyan now in play, multi-forum and parallel actions for alleged violations of the Securities Act present at least five Section 11 damages issues that complicate how allegedly defrauded IPO (and SPO) investors will attain equitable redress.

First, a uniform methodology for estimating aggregate damages for proposed classes in parallel Securities Act actions that are filed in federal and state court is very likely inapplicable due to different and potentially overlapping class definitions.

Second, given different filing dates of the parallel actions, the applied estimation of the number of shares that were purchased in connection with the IPO (or SPO) and retained at the time of the filing, is based on speculative techniques that may not conform with established Section 11 damages methodologies at the federal court level. At some point in the litigation life cycle, the qualified damages experts for each of the appointed lead plaintiffs of the corresponding classes (or subclasses), will be required to provide an independent calculation that estimates the number of outstanding shares that were not purchased in the aftermarket and are retained at the time when the claims were filed. There is some probability that the estimated recompense for some class members will be at the expense of investors in a different certified class (or subclass).

Third, no uniform standards exist at the federal or the state court level that specifically indicate the number of trading sessions that can elapse once the allegedly damaged — and newly minted — shares are no longer traceable to the IPO (or SPO).

Fourth, quantifying the effects of negative causation has material implications to differing damages methodologies between federal and state claims because the corresponding pleading requirements for each are distinctly different. Controlling for negative causation requires breaking the class period time frame into separate intervals that are related to the trading sessions that correspond with the alleged corrective disclosures. A Securities Act claim that does not account for negative causation in the estimate of maximum recoverable damages may be terminated based on established case precedent at the federal court level.[9]

Fifth, the estimation of artificial inflation that is alleged to be embedded in stock price may overlap and create conflicting recoveries for investors from different proposed classes (or subclasses). As a result, any state court judge tasked with settlement approval will be faced with significant challenges in accepting a plan of allocation that is equitable for investors in the certified classes. Parallel and multiforum Securities Act claims present observable Section 11 damages issues that may complicate equitable recompense for all allegedly defrauded investors.

The legal community will continue to attain economic benefits from the lack of clarity and transparency that Cyan has jammed into the judicial system. Corporations — and investors in these corporations — are paying a steep price to protect their directors and officers from this foggy problem that has muddied the waters. Lawyers that are currently embattled in parallel Securities Act litigation find themselves entrenched in a web of complexity that is highlighting cracks in the U.S. class action mechanism.

Cyan-related legal maneuvering is now hidden behind hundreds of sealed legal motions that inhibit transparency in the securities class action arena. "Cyan is an end, not a beginning[.]"[10] Congress should intervene and amend the Securities Litigation Uniform

Standards Act of 1998 to place exclusive jurisdiction of class actions that allege violations of the Securities Act in the U.S. federal court system.

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[1] "The Supreme Court's Cyan Decision and What Happens Next," posted by Michael S. Flynn, Paul S. Mishkin, and Edmund Polubinski III of Davis Polk & Wardwell LLP, in the Harvard Law School Forum on Corporate Governance and Financial Regulation on May 3, 2018.

[2] "D&O Insurance Costs Soar as Investors Run to Court over IPOs," Insurance Journal, June 18, 2019.

[3] John C. Coffee, "The Globalization of Entrepreneurial Litigation: Law, Culture, and Incentives." University of Pennsylvania Law Review, Vol. 165: 1895.

[4] "Keeping Pace with Digital Disruption in our Securities Marketplace," posted by Kara M. Stein, U.S. Securities and Exchange Commission, in the Harvard Law School Forum on Corporate Governance and Financial Regulation, on March 6, 2015.

[5] "Artificial Intelligence and the Future of Humans," Pew Research Center, December 2018.

[6] In Re Snap Securities Litigation.

[7] "Guest Post: The State of Securities Litigation After Cyan," Doug Greene, Jessie Gabriel, Marco Molina, and Brian Song of Baker & Hostetler; The D&O Diary, posted on April 23, 2018.

[8] Roman L. Weil, Frank, Hughes, Wagner. Litigation Services Handbook: The Role of the Financial Expert, 4th Edition, John Wiley & Sons, Inc., January 2007.

[9] In re Barclays Bank PLC Sec. Litig.

[10] "Major developments in class action litigation: what to watch for throughout 2019," DLA Piper, June 19, 2019.

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