American Bar Association, Section of Litigation, Class Actions & Derivative Suits Committee

Why We Need a State-Level Private Securities Litigation Reform Act

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A year and a half ago, the U.S. Supreme Court held in *Cyan, Inc. v. Beaver County Retirement Fund*, 138 S. Ct. 1061 (2018), that state courts have concurrent jurisdiction over class actions arising exclusively under the Securities Act of 1933 and that such actions are not removable to federal court. Since then, the number of Securities Act class actions filed in state court has, as many predicted it would, increased. According to the *2019 Midyear Assessment of Securities Class Action Filings* by Cornerstone Research, stockholders filed 13 Securities Act class actions in state courts in 2017 and 34 such actions in 2018, and are projected to file 38 actions by the end of 2019. Most of the actions are filed either in California or, with increasing frequency, in New York state courts. Oftentimes, parallel actions are filed in federal court.

State courts do not apply all the same protections against Securities Act strike suits that federal courts apply. The Private Securities Litigation Reform Act of 1995 (PSLRA), imposes a number of protections aimed at curbing perceived abuses in securities class actions involving nationally traded securities. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 82 (2006). Certain of those protections by their own terms do not apply in state court because they apply only to an action "that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure." 15 U.S.C. § 77z-1(a). Those include requirements designed to ensure that the class action vehicle furthers the interests of the stockholders, rather than "class action lawyers." *Id.*

They include a requirement that the plaintiff attach a "sworn certification" to his or her complaint attesting to, among other things, the plaintiff's transactions in the relevant security, *id.* § 77z-1(a)(2); a notice and motion procedure for the appointment of a lead plaintiff and lead counsel, *id.* § 77z-1(a)(3); restrictions on recovery by the plaintiff, *id.* § 77z-1(a)(4); and requirements related to settlements, *id.* § 77z-1(a)(5)–(a)(7).

Other provisions of the PSLRA, by their own terms, do apply in state courts. For example, the PSLRA provides that "[i]n any private action arising under [the Securities Act], all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss." *Id.* § 77z-1(b)(1). Because this automatic stay of discovery applies "[i]n any private action," it applies in state court according to its plain language. Similarly, in *Cyan*, the Supreme Court acknowledged that the so-called "safe harbor" for forward-looking statements applies in state court. *See Cyan*, 138 S. Ct. at 1072. Unlike the provisions that are limited to class actions "filed pursuant to the Federal Rules of Civil Procedure," the safe harbor also applies "in any private action arising under [the Securities Act]." 15 U.S.C. § 77z-2(c)(1).

Despite the plain language of the statute, state courts have not uniformly applied the automatic stay of discovery. Some courts have properly recognized that the discovery stay applies in both state and federal court. *See Matter of Everquote, Inc. Sec. Litig.*, 65 Misc. 3d 226, 106 N.Y.S.3d 828, 2019 N.Y. Slip Op 29242 (N.Y. Sup. Ct. Aug. 6, 2019). However, other courts have refused to apply it, concluding that it is "of a procedural nature," *Switzer v. Hambrecht & Co., LLC*, No. CGC 18 564904, 2018 WL 4704776 (Cal. Super. Ct. Sept. 19, 2018), or that it would somehow "undermine *Cyan's* holding that [Securities] Act cases may be heard in state courts," *Matter of PPDAI Grp. Sec. Litig.*, 64 Misc. 3d 1208(A), 2019 N.Y. Slip Op 51075(U) (N.Y. Sup. Ct. July 1, 2019); *see also In re Dentsply Sirona, Inc. v. XXX*, 2019 N.Y. Slip Op 32297(U), 2019 WL 3526142 (N.Y. Sup. Ct. Aug. 7, 2019) (same).

Any divergence between state and federal courts regarding application of all the protections of the PSLRA—whether because the protections by their terms apply only to cases brought in federal court or because of judicial error—undermines the overarching purpose of the PSLRA to reduce frivolous litigation. For example, prior to the enactment of the PSLRA, lead plaintiffs often were not selected based on who would best represent the class but on who won the "race to the courthouse" by filing his or her complaint first. *See In re Cavanaugh*, 306 F.3d 726, 729 (9th Cir. 2002). For that reason, "[l]ead plaintiffs were often unsophisticated investors who held small claims, and according to some reports, they were sometimes paid 'bounties' by lead counsel in exchange for their 'services.'" *I d.* The PSLRA notice and motion procedure for appointing lead plaintiff and lead counsel avoids this situation by requiring the court to appoint as lead plaintiff the putative class member whom "the court determines to be most capable of adequately

representing the interests of class members." 15 U.S.C. § 77z-1(a)(3)(B). This is presumably the person who "has the largest financial interest in the relief sought by the class" and who "otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure." *Id.* § 77z-1(a)(3)(B)(iii)(I)(bb)–(cc).

However, because the lead plaintiff process does not apply in state court, an "unsophisticated investor" with a "small claim" can avoid the scrutiny of the lead plaintiff process simply by filing in state court. The efficacy of the PSLRA in protecting the interests of class members is thereby compromised. In the context of parallel state and federal actions, a plaintiff filing in state court to avoid the lead plaintiff process may also create inconsistency or impair comity between the courts. In particular, the PSLRA creates a 90-day period at the beginning of the case for the plaintiff to provide public notice of the putative class action, for any interested putative class member to move to be appointed lead plaintiff, and for the court to appoint the lead plaintiff and lead counsel. *See id.* § 77z-1(a)(2). Because state courts do not use this procedure, a state court action filed at approximately the same time as a federal action may proceed ahead of a federal action at the beginning. This could provide a state court plaintiff an opportunity to wrest control of the litigation on behalf of the putative class regardless of the federal court's decision about which plaintiff is the "most capable of adequately representing the interests of class members." *Id.* § 77z-1(a)(3)(B). This could effectively render the federal court's lead plaintiff appointment moot. *See In re BankAmerica Corp. Sec. Litig.*, 263 F.3d 795, 803 (8th Cir. 2001) (noting that the rights conferred by PSLRA lead plaintiff provisions "are meaningless if a state-court plaintiff who has won the race to the state courthouse may seize control of the litigation of the federal claims").

Similarly, any failure of state courts to impose the automatic discovery stay risks inviting the type of early, vexatious discovery requests that the PSLRA meant to eliminate. *See SG Cowen Sec. Corp. v. U.S. District Court*, 189 F.3d 909, 911 (9th Cir. 1999) (explaining that automatic discovery stay is intended to "prevent unnecessary imposition of discovery costs on defendants"). As the court in *In re Everquote Inc. Securities Litigation* observed, failure of state courts to impose the automatic discovery stay

> would create the undesirable (and unsupported by the text of the statute or its purpose) and absurd incentive for lawsuits brought under the [Securities] Act to be brought in state court as opposed to federal court to avoid the very protection supporting the enactment of the [PSLRA] and necessarily confounding Congress' acknowledged intention that the lion's share of securities litigation would occur in the federal courts.

Everquote, 65 Misc. 3d at 239 (citing *Cyan*, 138 S. Ct. at 1073 (describing policy that "federal courts would play the principal role in adjudicating securities class actions")).

One option to correct the current state of affairs is for Congress to act. Congress could make federal courts the exclusive forum for class actions arising under the Securities Act or make such actions removable, while taking no action to affect state court jurisdiction over claims arising under state law or pertaining to the internal affairs of the corporation. However, it does not appear that Congress has considered taking such action. In 2018, bills were introduced in the House of Representatives and the Senate that would have, generally speaking, made federal courts the exclusive jurisdiction for "securities fraud" actions involving nationally traded securities and made such actions removable. *See* Securities Fraud Act of 2018, H.R. 5037, 115th Cong. § 29(b) (2018); Blue Sky Harmonization Act, S. 3421, 115th Cong. § 29(c) (2018). "Securities fraud" was defined in a way to include many claims arising under the Securities Act. However, these bills also stripped state courts of jurisdiction to hear "securities fraud" claims based on state law (an action this article does not propose). In any event, no action was taken on the two bills beyond referring them to the appropriate committees.

Barring action by Congress, state legislatures have a role to play. In particular, state legislatures, starting with California, should enact their own PSLRA. These acts would require state courts hearing Securities Act actions to apply the protections of the PSLRA to the same extent they would apply in federal court. For those PSLRA provisions that apply only when an action "is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure," 15 U.S.C. § 77z-1(a)(1), the state law would state that the provisions of this section apply in each private action brought in the courts of the state that arises under the federal Securities Act of 1933 and that is brought as a plaintiff class action. The provisions that came after it would be exactly like those set out in the PSLRA, with minor modifications to change any references to the Federal Rules of Civil Procedure to the state's parallel procedural rules. *See id.* § 77z-1(a)(1)–(8).

For those PSLRA provisions that already apply in state court because they apply to "any private action arising under" the Securities Act, *see id.* § 77z-1(b)(1), (c)(1), (d), § 77z-2(c), the state legislature could still separately enact those provisions verbatim, providing that they apply in any private action brought in the courts of the state arising under the federal Securities Act of 1933. This would make clear that those state courts that have refused to apply the provisions of the PSLRA that apply by their plain language have done so incorrectly and would leave no doubt (to the extent there is any) that these protections apply.

A state-level PSLRA would prevent states from becoming a haven for plaintiffs wishing to avoid the requirements of the very federal laws they invoke. It also would promote predictability, consistency, and fairness when it comes to litigating Securities Act cases in state courts.

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