Securities Litigation: Class Actions Arising from IPOs

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A Practice Note explaining the key attributes of securities class actions based on the offering materials for an initial public offering (IPO). This Note reviews the claims that plaintiffs typically assert, the jurisdictional issues that may arise, common challenges to plaintiffs' claims, affirmative defenses, and damages and the apportionment of liability.

An initial public offering (IPO) is a significant event that marks a corporation's transition from private to public ownership. After an IPO, an issuer benefits from its access to public capital markets and investors benefit from both increased liquidity for their investments and more transparency into the issuer's operations and financial results. However, IPOs also introduce a new form of risk for the corporation: investor litigation under the federal securities laws. In 2016, 3.9% of US exchange-listed companies were named as defendants in federal securities class actions (Cornerstone Research, *Securities Class Action Filings — 2016 Year in Review*, at 1, 10 (2017) (Cornerstone 2016 Year in Review)).

In recent years, driven by the wave of filings that followed the economic dislocations of the 2008 financial crisis, courts have paid increasing attention to aspects of claims brought under the federal securities laws, especially those involving the Securities Act of 1933 (Securities Act). These cases have given rise to various unsettled legal issues, which have the potential to greatly impact the filing and resolution of securities class actions going forward, including those challenging disclosures in connection with IPOs. This Note reviews the key attributes of securities class actions based on the offering materials for an IPO.

IPO PROCESS AT A GLANCE

The IPO process is governed by the Securities Act and its implementing rules and regulations. Subject to specific exemptions, Section 5 of the Securities Act prohibits:

- Offers to sell securities in interstate commerce unless a registration statement concerning the securities has been filed with the SEC.
- The sale of securities unless a registration statement is in effect.

(15 U.S.C. § 77e.)

This framework requires an issuer to compile certain information and disclose it in a registration statement and prospectus publicly filed with the Securities and Exchange Commission (SEC) and made available to investors. The required disclosures include information concerning, among other things:

- The nature of the issuer's business.
- The issuer's financial performance.
- The issuer's management and corporate governance.
- Risk factors relating to an investment in the issuer's securities.

Underwriters play an important role in this process as intermediaries that assist in an orderly distribution of the registered securities into the public capital markets and as gatekeepers that conduct due diligence into matters disclosed in the offering materials. The liability provisions of the Securities Act enforce this gatekeeper role by permitting claims against underwriters subject to certain statutory defenses (see The Due Diligence Defense).

Once an IPO has been completed, the registered shares are traded on the relevant stock exchange on which they have been listed. The issuer, in turn, is responsible for complying with the continuous disclosure requirements and other obligations applicable to all US exchange-listed companies under the Securities Exchange Act of 1934 (Exchange Act) and the rules and regulations thereunder.

In 2012, the enactment of the Jumpstart Our Business Startups (JOBS) Act amended the securities laws to lessen the burden of the IPO process for emerging growth companies, and a large percentage of IPOs now involve companies invoking those provisions. However, the JOBS Act did not significantly alter the framework for potential liability following an IPO for that category of issuers.

For information on the disclosure accommodations available to emerging growth companies under the JOBS Act, see What's Market: Disclosing the Implications of the JOBS Act in IPO Prospectuses (0-519-4267).

For a collection of resources to assist issuers, underwriters, and their counsel in conducting IPOs in compliance with the Securities Act's registration and disclosure requirements, see Initial Public Offerings Toolkit (2-578-7625).

PRINCIPAL CLAIMS

Both the Securities Act and the Exchange Act create incentives for full disclosure by issuers and other participants in the IPO process and provide vehicles to compensate investors harmed by securities violations. The registration statement and prospectus that together constitute the offering materials for an IPO can give rise to claims under both statutory frameworks, which provide purchasers and sellers of securities with several express and implied causes of action.

When the number of IPOs increases in the capital markets, the number of class actions asserting claims under the Securities Act rises in parallel. Between 2013 and 2015, the number of these actions more than doubled following a similar trend in the number of IPOs. Conversely, in 2015, the number of IPOs declined by 40%, and a similar drop in class actions under the Securities Act followed in 2016. (Stefan Boettrich and Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2016 Full-Year Review*, NERA Economic Consulting, at 8 (2017) (NERA 2016 Full-Year Review).)

The claims that plaintiffs typically assert in IPO-related securities class actions arise under:

- Section 11 of the Securities Act (see Section 11 of the Securities Act).
- Section 12(a)(2) of the Securities Act (see Section 12(a)(2) of the Securities Act).
- Section 10(b) of the Exchange Act, as implemented by the Securities and Exchange Commission's (SEC's) Rule 10b-5 (see Section 10(b) of the Exchange Act and SEC Rule 10b-5).
- Section 15(a) of the Securities Act and Section 20(a) of the Exchange Act, for secondary liability claims against a "control person" (see Control Person Liability).

For more on these provisions, see Practice Notes, Liability Provisions: Securities Offerings (6-381-1466) and Securities Litigation: Liability Provisions Under the Securities Act and the Securities Exchange Act (w-000-8585).

SECTION 11 OF THE SECURITIES ACT

Section 11 of the Securities Act permits claims based on material misstatements or omissions in a registration statement and imposes a stringent standard of liability on parties directly involved with a registered offering. However, liability can arise only for statements that were false or misleading at the time the registration statement became effective. (15 U.S.C. § 77k(a).)

A registration statement includes the prospectus and other information required to be disclosed in connection with a registered offering under Section 7 of the Securities Act and its implementing rules. Section 11 does not apply to oral communications or preliminary prospectuses. In addition, aftermarket statements such as roadshow presentations, analyst reports, and conference calls with investors generally are outside the reach of the statute. However, Section 11 can apply to statements in a prospectus supplement, which is deemed part of the registration statement as of the date it is first used.

A Section 11 plaintiff is not required to establish that:

- He relied on the challenged misstatement or omission.
- The defendant acted with a specific state of mind.

SECTION 12(A)(2) OF THE SECURITIES ACT

Section 12(a)(2) of the Securities Act provides a cause of action for material misstatements or omissions made by any person "who offers or sells a security" in a public offering of registered securities by means of a "prospectus or oral communication" (15 U.S.C. § 77***l***(a)). As with claims under Section 11, a plaintiff asserting a claim under Section 12(a)(2) is not required to establish reliance on the challenged misstatement or omission or the defendant's state of mind.

SECTION 10(B) OF THE EXCHANGE ACT AND SEC RULE 10B-5

Section 10(b) of the Exchange Act prohibits fraud in the purchase or sale of securities (15 U.S.C. § 78j(b)), and SEC Rule 10b-5, its implementing regulation, contains the catch-all anti-fraud provision of the federal securities laws (17 C.F.R. § 240.10b-5).

Although Section 10(b) and Rule 10b-5 do not provide an express private right of action, federal courts have developed over time an implied private right of action based on common law principles.

To state a cause of action under Section 10(b) and Rule 10b-5, a private plaintiff must establish that:

- The plaintiff was a purchaser or seller of the securities.
- The defendant made a misstatement of material fact or failed to state a material fact necessary to make statements that were made not misleading.
- In the case of an alleged omission, the defendant had a duty to disclose the information allegedly withheld.
- The plaintiff relied to his detriment on the false or misleading statement.
- The plaintiff suffered damages that were caused by the false or misleading statement.
- The defendant made the challenged statements with scienter, that is, an intention to defraud.

Scienter can be based on an actual intent to defraud or a disregard for the truth so reckless that it amounts to the same. Under the Private Securities Litigation Reform Act (PSLRA), a securities fraud complaint must set forth sufficiently particular facts to permit a "strong inference" that the defendant acted with scienter in making the challenged misstatement or omission (15 U.S.C. § 78u-4(b)(2); see *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 321-24 (2007)).

Only the "maker" of an allegedly fraudulent misstatement or omission can be liable in a private action brought under Rule 10b-5. The maker of a statement is the person with ultimate authority over it, including its content and whether and how to communicate it. A person who prepares a statement for another, such as a lawyer who assists in preparing offering materials or other disclosure documents, is not the maker of the statement. (*Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142-43 (2011).)

For a collection of resources to help counsel defend lawsuits brought by private plaintiffs under Section 10(b) and Rule 10b-5, including more on each of the elements of a securities fraud claim, see Defending Federal Securities Fraud Claims Toolkit (w-004-5011).

CONTROL PERSON LIABILITY

Section 15(a) of the Securities Act (15 U.S.C. § 77o(a)) and Section 20(a) of the Exchange Act (15 U.S.C. § 78t(a)) provide for joint and several liability of any person who directly or indirectly controls a person found liable for a primary violation of the statutes discussed above. "Control" means that a named defendant has "the power to direct or cause the direction of the management and policies" of a person (*Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890 (3d Cir. 1975) (citing 17 C.F.R. § 240.12b-2); see *In re Lehman Bros. Mortg.-Backed Sec. Litig.*, 650 F.3d 167, 185 (2d Cir. 2011) (adopting the same definition for Section 15(a) claims)).

In securities class action complaints concerning IPOs, it is not unusual for plaintiffs to assert control person claims against the issuer's most senior officers and the members of its board of directors. However, merely alleging a defendant's status as an officer or a director with no allegations of the defendant's actual control generally is insufficient (see, for example, *Suez Equity Inv'rs, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 102 (2d Cir. 2001)). At least for claims under Section 20(a), some courts also require plaintiffs to establish that a named defendant was a "culpable participant" in the underlying violation, which requires plausible allegations of the defendant's knowledge of, and involvement in, the alleged primary violation.

For more information on defending against control person liability claims under the federal securities laws at the motion to dismiss and motion for summary judgment stages, see Practice Note, Securities Litigation: Defending Against Control Person Claims (w-002-7389).

JURISDICTIONAL ISSUES

Class actions asserting securities fraud claims under Rule 10b-5 must be brought in federal court, and that is also true for class actions asserting claims under both the Exchange Act and the Securities Act. However, there is considerable uncertainty about whether state courts have concurrent jurisdiction over class actions that exclusively assert Securities Act claims. Courts have reached conflicting conclusions as to whether the Securities Litigation Uniform Standards Act of 1998 (SLUSA) ousted state courts of their concurrent subject matter jurisdiction in those actions.

As originally enacted, the Securities Act provided for concurrent jurisdiction in state and federal courts and prohibited removal of Securities Act claims to federal courts. In 1998, Congress enacted SLUSA to address perceived abuses in securities class actions following the earlier enactment of the PSLRA. SLUSA amended the concurrent jurisdiction provision of the Securities Act to divest state courts of subject matter jurisdiction over "covered class actions," meaning class actions that involve common questions of law or fact brought on behalf of more than 50 persons or actions brought on behalf of one or more unnamed parties. Additionally, SLUSA amended the anti-removal provision to permit removal of any "covered class action brought in any State court involving a covered security." (15 U.S.C. §§ 77p(c), 77v(a).)

Congress intended these provisions to give federal courts exclusive jurisdiction over covered class actions (15 U.S.C. § 77p(f)(2)(A)(i)(II)). Courts have divided, however, on whether that exclusive jurisdiction extends to class actions that assert only Securities Act claims. The fact that this issue arises in connection with decisions on removal and remand, which are not easily reviewed on appeal, has meant that most of the decisions on both sides of the divide have been issued by the federal district courts instead of the appellate courts.

In some jurisdictions, especially California, the filing of state court class actions asserting Securities Act claims is now commonplace. During 2015 and 2016, 33 state court Securities Act class actions were filed in California. Statistics suggest that those state court actions are more likely to survive beyond the motion to dismiss stage, and therefore are more likely to be settled, than similar class actions pending in federal court. (See Cornerstone 2016 Year in Review, at 16, 18.)

At present, courts within the Second Circuit are likely to permit removal of state court class actions that exclusively assert Securities Act claims, while courts within the Ninth Circuit are almost certain to hold that removal of such actions is not permissible. A pending case has provided the Supreme Court with a rare opportunity to resolve this significant division in authority (see Box, The Question of Concurrent Jurisdiction).

COMMON CHALLENGES TO PLAINTIFFS' CLAIMS

Defendants commonly move to dismiss securities class actions arising from an IPO based on arguments that:

- The plaintiff lacks standing (see Lack of Standing).
- The plaintiff is bringing the case against an improper defendant (see Improper Defendant).
- The plaintiff has not identified a material misstatement or omission (see No Material Misstatement or Omission).
- The statements at issue are non-actionable statements of opinion or belief (see Statements of Opinion or Belief).
- The case involves a non-actionable forward-looking statement (see Forward-Looking Statements).

LACK OF STANDING

Both Section 11 and Section 12(a)(2) of the Securities Act limit the categories of eligible plaintiffs.

Section 11 claims are available to any person who purchased or otherwise acquired securities registered pursuant to a registration statement containing a material misstatement or omission, whether he bought the securities directly from the issuer or underwriter or in the aftermarket (15 U.S.C. § 77k(a)). However, the following limitations apply:

- If the plaintiff acquired the securities after the issuer released an earnings statement covering a period of at least 12 months beginning after the effective date of its registration statement, the plaintiff must establish that he actually relied on the alleged misstatement or omission in acquiring the securities (15 U.S.C. § 77k(a)).
- Aftermarket purchasers must "trace" their securities to the challenged offering. This becomes increasingly difficult when there has been more than one offering of the securities or the securities have entered the markets through other means (such as founders' shares or employee benefit plans). Courts have rejected plaintiffs' attempts to trace their securities through a statistical analysis (see *Krim v. pcOrder.com, Inc.*, 402 F.3d 489, 494-502 (5th Cir. 2005); *In re Puda Coal Sec. Inc. Litig.*, 2013 WL 5493007, at *6-9 (S.D.N.Y. Oct. 1, 2013)).

- Section 11 does not permit recovery for any person who knew of the alleged misstatement or omission at the time he acquired the securities (15 U.S.C. § 77k(a)).

The class of eligible plaintiffs is narrower for claims under Section 12(a)(2), which requires a plaintiff to have purchased the subject security in the offering itself and not in the aftermarket (*Gustafson v. Alloyd Co.*, 513 U.S. 561, 577-78 (1995)). As with Section 11 claims, a purchaser that had knowledge of the alleged untruth or omission at the time of the purchase or acquisition of the securities cannot recover under Section 12(a)(2) (15 U.S.C. § 77***l***(a)(2)).

IMPROPER DEFENDANT

Section 11(a) of the Securities Act sets out the following exclusive categories of defendants:

- Persons who signed the registration statement.
- Directors of, or persons performing similar functions, or partners in the issuer at the time of the filing of the part of the statement with respect to which their liability is asserted.
- Persons who, with their consent, are named in the registration statement as being or about to become a director of, or person performing similar functions, or partner in the issuer.
- Every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified the registration statement or any report or valuation used in connection with the registration statement, with respect to that statement.
- The underwriters.

(15 U.S.C. § 77k.)

Section 12(a)(2) of the Securities Act limits liability to any person who "offers or sells a security" to the plaintiff (15 U.S.C. § 77***l***(a)(2)). A seller can refer to either:

- A person who passed title to the buyer for value.
- A person who solicits purchases of the security, "motivated at least in part by a desire to serve his own financial interest or those of the securities owner."

(*Pinter v. Dahl*, 486 U.S. 622, 647 (1988).)

Since the Supreme Court's decision in *Pinter v. Dahl*, there has been uncertainty about whether an issuer could be considered a seller for purposes of Section 12(a)(2) liability in a firm-commitment underwriting. In this predominant form of underwriting, the issuer sells securities to the underwriters who then sell them to investors in the offering. In amendments to its Securities Act rules, the SEC has taken the position that an issuer should be considered a seller under Section 12(a)(2) even in firm-commitment underwritings (17 C.F.R. § 230.159A(a)). However, some courts have not accepted the SEC's view (see, for example, *In re Kosmos Energy Ltd. Sec. Litig.*, 955 F. Supp. 2d 658, 672 (N.D. Tex. 2013); *In re Thornburg Mortg., Inc. Sec. Litig.*, 695 F. Supp. 2d 1165, 1219-20 (D.N.M. 2010), on reconsideration, 824 F. Supp. 2d 1214 (D.N.M. 2011)).

Defendants may challenge a plaintiff's claim under Section 10(b) of the Exchange Act and Rule 10b-5 on the ground that the defendant did not "make" the statement under *Janus* (see Section 10(b) of the Exchange Act and SEC Rule 10b-5).

NO MATERIAL MISSTATEMENT OR OMISSION

The cornerstone of any claim under Section 11 or Section 12(a)(2) of the Securities Act and Rule 10b-5(b) under the Exchange Act is an alleged misstatement or omission of a material fact. A material fact is one that a reasonable investor would have viewed as "having significantly altered the 'total mix' of information made available" (*TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

Prevailing on a motion to dismiss based on a materiality argument can be challenging. Whether a fact is material generally is viewed as a mixed question of law and fact requiring a contextual analysis. The Supreme Court has cautioned against the use of statistical thresholds to establish that a fact was not material (*Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 40-41 (2011)).

Some courts have held that information required to be disclosed by Regulation S-K is presumptively material (see, for example, *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998)), while others view that requirement as evidence of the materiality of a given fact (see, for example, *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 102 (2d Cir. 2015)).

Certain information is considered immaterial and need not be disclosed as a matter of law. For example, courts have held that there is no duty to disclose:

- Publicly available facts, because they are already part of the total mix of information available to investors (*Kapps v. Torch Offshore, Inc.*, 379 F.3d 207, 216 (5th Cir. 2004); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 249-50 (S.D.N.Y. 2003)).
- Uncharged and unadjudicated wrongdoing, on grounds that disclosure "is not a rite of confession" (*City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 184 (2d Cir. 2014)).

Accordingly, while materiality often can be a fact-intensive inquiry, courts will dismiss claims where the alleged misrepresentation or omission is so obviously unimportant that reasonable minds could not differ on its immateriality (see *Klein v. Gen. Nutrition Co.*, 186 F.3d 338, 342-343 (3d Cir. 1999); *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 546-47 (8th Cir. 1997)).

STATEMENTS OF OPINION OR BELIEF

Whether an alleged statement is actionable is a more difficult question when a complaint challenges statements of opinion or belief — a broad category that extends to accounting estimates included in an issuer's financial statements, descriptions of ongoing legal proceedings and their likely outcome, and assessments of the issuer's competitive position in its industry, among many other matters.

In *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, the Supreme Court held that statements of opinion do not give rise to liability under Section 11 of the Securities Act, unless either:

- The speaker did not actually hold the stated belief.
- The plaintiff identifies "particular (and material) facts going to the basis" for the opinion whose omission "makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."

If a registration statement omits material facts about the issuer's inquiry into, or knowledge concerning, a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then the omission may be actionable. However, the Supreme Court recognized that establishing omissions-based liability for statements of opinion post-*Omnicare* is "no small task." (135 S. Ct. 1318, 1326, 1329, 1332 (2015).)

Because most Securities Act plaintiffs specifically disclaim fraud to avoid the heightened pleading burdens for fraud allegations under FRCP 9(b), satisfying the *Omnicare* standard is often a plaintiff's only possible recovery based on an allegedly false or misleading statement of opinion.

Courts have extended the *Omnicare* holding to Rule 10b-5 claims (see, for example, *In re Lehman Bros. Sec. & ERISA Litig.*, 131 F. Supp. 3d 241, 252-55 & n.48 (S.D.N.Y. 2015)). Even before *Omnicare*, many courts had held that statements of opinion were actionable under Rule 10b-5 only to the extent that the statement was both objectively false and disbelieved by the defendant at the time it was expressed (see, for example, *City of Omaha, Ne. Civilian Emp. Ret. Sys. v. CBS Corp.* 679 F.3d 64, 67-68 (2d Cir. 2012)).

FORWARD-LOOKING STATEMENTS

Forward-looking statements refer to information such as estimates, projections, plans, and objections (15 U.S.C. §§ 77z-2(i), 78u-5(i)). Depending on the facts, forward-looking statements may be non-actionable in a securities class action under:

- **The statutory safe harbor for forward-looking statements created by the PSLRA.** Under these statutory provisions, a forward-looking misstatement or omission is not actionable unless it was made with actual knowledge of its falsity. This safe harbor is not available as a defense for claims based on forward-looking statements made in connection with an IPO. (15 U.S.C. §§ 77z-2, 78u-5.)
- **The "bespeaks caution" doctrine.** Under this judicially developed doctrine, which pre-dated the enactment of the PSLRA, forward-looking statements accompanied by meaningful cautionary language are not actionable. The cautionary language and disclosures must be precise and fact-specific and address the substance of each forward-looking statement. Generalized, boilerplate warnings are not sufficient. (See *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1120 (10th Cir. 1997); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994).)

SIGNIFICANT AFFIRMATIVE DEFENSES

The Securities Act provides defendants in IPO-related securities class actions with several statutory affirmative defenses, including:

- The statute of limitations or statute of repose (see Statute of Limitations and Statute of Repose).
- The defendants' due diligence (see The Due Diligence Defense).
- Negative causation (see Negative Causation).

STATUTE OF LIMITATIONS AND STATUTE OF REPOSE

Section 13 of the Securities Act requires that claims under Section 11 and Section 12 must be brought within one year after discovery of the alleged violation but in no event more than three years after the public offering or sale, as follows:

- **The one-year statute of limitations.** The limitations period begins to run after the plaintiff obtains actual knowledge of the facts giving rise to the action or notice of the facts which, in the exercise of reasonable diligence, would have led to actual knowledge. A duty to inquire arises when the circumstances would suggest to aninvestor of ordinary intelligence the probability that he has a cause of action. (*In re IndyMac Mortg.-Backed Sec. Litig.*, 718 F. Supp. 2d 495, 502-03 (S.D.N.Y. 2010).) A plaintiff bears the burden of establishing that he commenced the action within the statute of limitations and, therefore, must demonstrate when he knew or should have known of the allegedly wrongful act.
- **The three-year statute of repose.** This is the statutory "cutoff" for asserting claims under the Securities Act. For Section 11 claims, the period begins when the security is "bona fide offered to the public," which most courts consider to be the date the SEC deemed the registration statement to be effective. For Section 12(a)(2) claims, the period begins to run on the date of the last sale of securities pursuant to the allegedly misleading prospectus. The US Supreme Court recently ruled that *American Pipe* does not toll claims filed more than three years after the relevant securities offering (*Cal. Pub. Emps. Ret. Sys. v. ANZ Secs., Inc. (CalPERS)*, 2017 WL 2722415 (U.S. June 26, 2017); see Box, Tolling of the Section 13 Statute of Repose).

(15 U.S.C. § 77m.)

Therefore, Section 13 has been described by courts as setting forth a statute of limitations framed by a statute of repose.

THE DUE DILIGENCE DEFENSE

Non-issuer defendants can avoid liability under Section 11 of the Securities Act by demonstrating that they conducted a "reasonable investigation" with regard to the portions of the registration statement for which they were responsible (15 U.S.C. § 77k(b)(3)). Similarly, Section 12(a)(2) of the Securities Act provides a defense for defendants who, in the exercise of "reasonable care," could not have known of the alleged misstatement or omission (15 U.S.C. § 77***l***(a)(2)). Courts generally have construed these two defenses similarly (*In re WorldCom Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 663-64 (S.D.N.Y. 2004)).

Underwriters and other non-expert defendants, such as directors or officers, can defeat liability under the Section 11 due diligence defense by demonstrating that they met the applicable standard of care, which depends on whether the challenged portion of the registration statement was "made on the authority of an expert" (15 U.S.C. § 77k(b)(3)). Specifically, the standard applies as follows:

- **Expertised portions.** Examples of expertised portions of a registration statement include the audit opinion from an independent registered accounting firm concerning the registrant's financial statements or a report from an independent petroleum engineer concerning a registrant's oil and gas reserves. A non-issuer defendant can avoid liability for expertised portions of a registration statement if it "had no reasonable ground to believe and did not believe" that a material misstatement or omission existed. Courts sometimes refer to this as the reliance defense because the underwriters and other non-issuer defendants are permitted to rely in good faith on the work of the relevant expert for those portions of the registration statement.
- **Non-expertised portions.** A non-issuer defendant can avoid liability for non-expertised portions of a registration statement if

the defendant shows that it "had, after reasonable investigation, reasonable ground to believe and did believe" that there was no material misstatement or omission (15 U.S.C. § 77k(b)(3)(A)). The standard of care under this part of the provision is understood to be negligence.

For more information on due diligence investigations in connection with SEC-registered and unregistered securities offerings, see Practice Note, Due Diligence: Securities Offerings (4-380-7917).

NEGATIVE CAUSATION

In contrast with claims under Rule 10b-5, which require a plaintiff to plead and prove that its losses were caused by an alleged misstatement or omission, Sections 11 and 12 of the Securities Act provide a statutory affirmative defense that can limit or eliminate damages under those provisions to the extent defendants establish that the plaintiff's losses were caused by other factors (15 U.S.C. § 77k(e), 77***l***(b)).

Generally, such an affirmative defense cannot be addressed at the motion to dismiss stage in which the plaintiff is entitled to every reasonable inference in its favor. However, where the grounds for a loss causation defense appear in the complaint itself or documents it incorporates by reference, some courts have been willing to grant dismissal (see, for example, *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 429, 437 (S.D.N.Y. 2003)). Other courts have refused to do so given the statutory allocation of the burden of proof to defendants (see, for example, *In re WRT Energy Sec. Litig.*, 2005 WL 2088406, at *2 (S.D.N.Y. Aug. 30, 2005)).

DAMAGES AND APPORTIONMENT OF LIABILITY

Securities class actions arising from IPOs are subject to various rules and limitations concerning damages and the apportionment of liability.

DAMAGES

Section 11(e) of the Securities Act limits the damages available to a Section 11 plaintiff to the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and either:

- The value of the security as of the time the suit was brought.
- The price at which the security was disposed of in the market before suit.
- The price at which the security was disposed of after suit but before judgment if it is less than the difference between the purchase price and the value of the security at the time of suit.

(15 U.S.C. § 77k(e).) This list of damages theories is exclusive.

Section 12(a)(2) of the Securities Act provides for:

- A remedy of rescission, that is, "the consideration paid for the security with interest thereon, less the amount of any income received thereon, upon tender of the security."
- Rescissory damages, if the plaintiff no longer owns the security.

(15 U.S.C. § 77***l***(a)(2).)

APPORTIONMENT OF LIABILITY

Depending on the circumstances, indemnification or contribution rights may be available to shift or allocate liability in IPO-related securities class actions.

Indemnification

There is no express or implied right of indemnity under the Securities Act. While not dispositive, both the SEC and the courts have expressed disfavor of indemnification for liability under the statute (17 C.F.R. § 229.510; see *Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F.2d 672, 676 (9th Cir. 1980); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969)).

Nevertheless, it is typical for underwriters and others involved in the offering process to require contractual indemnification from the issuer or selling stockholders in connection with their work on an offering. Most Securities Act cases do not reach trial (see Settlement Trends), and these contractual indemnities typically are honored in cases that are resolved by motion or in a settlement before trial.

For actions under the Exchange Act, contractual indemnity rights are expressly enforceable under the PSLRA for defense costs by a prevailing defendant (15 U.S.C. § 78u-4(f)(2)(B)(ii)).

Contribution

Section 11 of the Securities Act expressly provides for joint and several liability and a right of contribution against those who would have been liable for the same payment if sued separately, unless the person seeking contribution was "guilty of fraudulent misrepresentation" while the other person was not (15 U.S.C. § 77k(f)(1)).

The PSLRA, through Section 21(D)(f) of the Exchange Act, added provisions for proportionate liability and a right of contribution in private actions under the federal securities laws, including claims under Section 11 of the Securities Act and Section 10(b) of the Exchange Act. In particular, under Section 21(D)(f):

- A covered person against whom a final judgment is entered in a private action is jointly and severally liable for damages only if he "knowingly" committed a violation of the securities laws.
- Absent a knowingly committed violation, the covered person is liable solely for the portion of the judgment that corresponds to his percentage of responsibility as determined by 15 U.S.C. § 78u-4(f)(3).
- A covered person may recover contribution from other covered persons and anyone else responsible for the violation.

(15 U.S.C. § 78u-4(f)(2), (5).)

A covered person is defined as any defendant in a private action under the Exchange Act and any defendant in a private action under Section 11 of the Securities Act who is an outside director (15 U.S.C. § 78u-4(f)(10)(C)).

The PSLRA also limits contribution claims following a settlement. When a covered person settles a private action, upon entry of the settlement by the court, the court must enter an order that bars all future contribution claims arising out of the action by:

- Any person against the settling covered person.
- The settling covered person against any person, other than a person whose liability has been extinguished by the settlement of the settling covered person.

(15 U.S.C. § 78u-4(f)(7)(A).)

Further, if a covered person has paid the plaintiff to settle claims, the PSLRA provides for judgment reduction for the non-settling defendants. The final judgment must be reduced by the greater of:

- An amount that corresponds to the percentage of responsibility of that covered person.
- The amount paid to the plaintiff by that covered person.

(15 U.S.C. § 78u-4(f)(7)(B).)

SETTLEMENT TRENDS

It is rare for a securities class action of any type to reach a trial verdict. Roughly 40% of securities class actions are dismissed at the pleadings stage on motions to dismiss, and when later pretrial motion practice is included that figure rises to roughly half of all filings (see NERA 2016 Full-Year Review, at 21; Cornerstone 2016 Year in Review, at 16). Most cases that are not resolved for defendants on motion are settled before trial (see Cornerstone 2016 Year in Review, at 13).

Although there is a high likelihood of a settlement in a case that is not dismissed, this does not imply riches for plaintiffs in these actions. The average settlement amount increased significantly for a second straight year in 2016, but two large settlements exceeding $1 billion were largely responsible for that increase. Excluding those settlements, the average 2016 settlement decreased by 19% when compared with the average in 2015. Large settlements, while less frequent, have an impact on average settlement figures. By contrast, the median settlement value each year since 1996 has ranged from $3.7 million to $12.3 million, with the median settlement in 2016 coming in at $9.1 million. (NERA 2016 Full-Year Review, at 31.)

Whether any given IPO-related securities class action will settle and at what price are complex questions that depend on various case-specific factors.

THE QUESTION OF CONCURRENT JURISDICTION

The issue of whether SLUSA ousted state courts of their concurrent subject matter jurisdiction over class actions that exclusively assert Securities Act claims is the subject of a case currently pending before the Supreme Court (*Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, 2017 WL 2742854 (U.S. June 27, 2017)).

In *Cyan*, the defendant in a California state court class action alleging only Securities Act claims filed a motion to dismiss for lack of subject matter jurisdiction based on SLUSA's amendment to Sections 16 and 22 of the Securities Act. The California trial court denied the motion to dismiss based on an earlier opinion by a California Court of Appeal in *Luther v. Countrywide Financial Corp.* (195 Cal. App. 4th 789 (Cal. Dist. Ct. App. 2011)), which rejected the argument that SLUSA requires all securities class actions to be brought in federal court.

The defendant appealed to the California Court of Appeal and then the California Supreme Court, but both courts declined to review the trial court decision. The Supreme Court granted the defendant's petition for *certiorari* in June 2017.

If the Supreme Court rules in Cyan's favor, the decision will bring an abrupt end to the proliferation of Securities Act class actions in state courts. Until then, counsel should expect that plaintiffs will continue to file an increasing number of IPO-related class actions alleging Securities Act claims in state courts.

TOLLING OF THE SECTION 13 STATUTE OF REPOSE

The Supreme Court recently held that the *American Pipe* tolling rule does not apply to the three-year period of repose for Securities Act claims (*CalPERS,* 2017 WL 2722415, at *10-11).

The case arose from the collapse of investment bank Lehman Brothers during the 2008 financial crisis. Before bankruptcy, Lehman Brothers raised billions of dollars through public debt offerings. Following the bankruptcy, a plaintiff filed a securities class action alleging that underwriters for those debt offerings were liable for false and misleading statements made in the registration statements. The class action settled, but CalPERS opted out of the settlement to pursue its own claims after the three-year repose period had elapsed.

The Supreme Court affirmed the Second Circuit's decision holding that the district court properly dismissed CalPERS' suit as untimely. It rejected the petitioner's argument, based on the Supreme Court's decision in *American Pipe*, that the earlier class action tolled the three-year repose period (*In re Lehman Bros. Sec. & ERISA Litig.*, 655 F. App'x 13, 15-16 (2d Cir. 2016)). Under *American Pipe*, the commencement of a class action suspends the applicable statute of limitations for all putative class members until class certification is denied, when class members can choose to file their own suit or intervene as plaintiffs in the pending action (414 U.S. at 554).

CalPERS holds that the three-year time limit in Securities Act Section 13 (15 U.S.C. § 77k(a)) is a statute of repose not subject to equitable tolling. The Supreme Court found that, because the tolling decision in *American Pipe* derived from equity principles, it cannot alter the unconditional language and the purpose of the 3-year statute of repose to provide the defendant a complete defense to any suit after a certain period. (2017 WL 2722415, at *10.)

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