Implications of Section 11 Claims on Directors and Officers Insurance

Newly public companies can miss earnings estimates or announce bad news shortly after going public. If the resulting stock drop is significant, a shareholder class action alleging violation of Section 11 of the Securities Act of 1933 for misstatements in a registration statement may be filed. Section 11 claims are currently being tested in the United States Supreme Court in *Cyan, Inc., et al. v. Beaver County Employees Retirement Fund, et al*. Understanding the risks — and how Section 11 claims will be litigated in state and federal courts — can help organizations ensure that they are adequately protected.

Under Section 11, there is strict liability for issuers for misstatements and omissions in their registration statements. As a result, directors and officers who sign the registration statements can face significant risks. At issue in the *Cyan* case is whether — pursuant to the Securities Litigation Uniform Standards Act of 1998 — state courts have concurrent subject-matter jurisdiction over class actions alleging solely violations of the Securities Act of 1933. This is a particularly critical issue for California-based companies where in recent years there has been a dramatic increase in the number of Section 11 cases filed in state courts. In 2016, shareholder plaintiffs filed approximately eighteen Section 11 suits in California state court, a significant jump over previous years.[1]

The concurrent jurisdiction issue in *Cyan* is being closely watched by the directors and officers (D&O) insurance industry for several reasons. First, allowing a Section 11 case to proceed in state court is a cause for concern for the defendants' insurers because, with typically lower dismissal rates, state courts are generally considered to be more plaintiff-friendly. A motion to dismiss is unlikely to be granted in such instances, meaning that the cases will almost automatically proceed to discovery, which is often the most expensive part of securities litigation. Federal courts, on the other hand, are considered to have more experience in adjudicating securities cases and have

[1] For example, approximately five Section 11 suits were filed in California state court in 2014.

specific procedures in place to curtail perceived plaintiff abuses.

Second, in addition to the protections of the Federal Rules of Civil Procedure, there is a more robust body of case law in federal court than in most state courts. If Section 11 cases are allowed to proceed in state court, there is a concern that the cases will take longer to defend and the outcome will be less favorable to the defendants. This may lead to higher defense costs and the potential for a costly adverse judgment or higher value settlement.

Understanding Section 11 risks can help ensure that organizations are adequately protected under their D&O policy. For example, dismissal rates in California state court are low. California state courts have more lenient pleading standards and permissive procedures than federal courts. Moreover, unlike other claims, plaintiffs in Section 11 cases do not have to show intent. The lower standard of liability for Section 11 claims, coupled with low dismissal rates for California state court cases, can make the process of placing D&O coverage especially important for a company about to undertake an initial public offering.

While the issue of whether Section 11 cases can be heard in state court continues to be unsettled, it is critical that companies considering an offering ensure that they purchase sufficient D&O insurance limits to protect the company and its directors and officers.

For more on this topic, contact your Marsh representative, or contact:

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