ARTICLES

Cyan Ruling a Catalyst for Securities Litigation (Part One)

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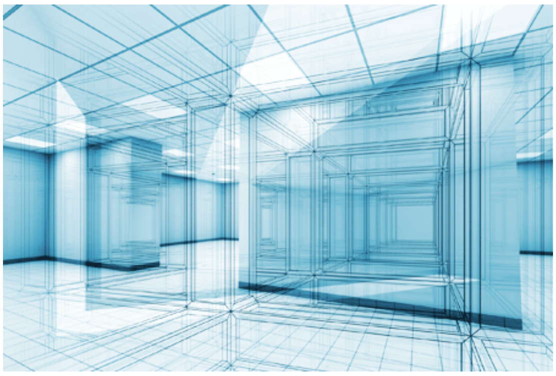

The basic calculus for investing in IPO securities is simple: you buy stock in a company at the time of the IPO, the value of the stock goes up, and you make money. But when you invest in an IPO, and the stock price goes down (for any number of reasons), many investors demand that the issuer of the stock pay. Lawyers are hired. Suits are filed. And the calculus is suddenly not so simple.

Companies have always faced a risk of securities litigation from investors seeking to recover damages when the actual value of stocks they bought is lower than the anticipated value of those stocks based on the issuer's registration statement. But the ripples of a March 20, 2018 U.S. Supreme Court ruling, "*Cyan Inc., v. Beaver County Employees Retirement Fund" ("Cyan")*, have turned into a tidal wave of exposure that is fundamentally changing the IPO market.

In a nutshell, the Cyan decision allows securities plaintiffs in class actions to avoid federal court by filing in state courts, which are more favorable to plaintiffs seeking to prove that they were misled the companies in which they invested.

Cyan opens new risks for companies going public and has *substantially increased insurance rates for public company D&O liability insurance.*

The need to hire an experienced broker and legal team to craft state-of-the-art contract language in preparing for an IPO has never been more important than it is today.

Background

The modern history of the laws governing securities litigation in America is long and nuanced. It starts with the Securities Act of 1933 ("'33 Act") which holds corporate issuers answerable to investors and ensures transparency and truthfulness in how they represent their companies in a prospectus. Under Section 11 of this law, issuers are held to a standard of liability for material misstatements and omissions in their registration statements that could causes losses to investors.

Section 11 opens exposure to officers, directors, underwriters and anyone involved in the creation of the registration statement in a company's IPO. A critical component of Section 11 is that state and federal courts have *concurrent jurisdiction* over private lawsuits and the defendants are not allowed to remove state filings in favor of federal filings.

Over the years, a series of reforms in securities litigation were passed as Congress recognized that companies were over-burdened with meritless claims and that these abuses were hurting the U.S. economy. In 1995, the "Private Securities Litigation Reform Act" ("PSLA") was passed, creating safeguards protecting defendants from abusive lawsuits.

However, plaintiffs' lawyers quickly realized they could evade PSLA's federal restrictions of by filing in state courts and began shopping around for the most favorable venues to file their claims. Congress reacted in 1998, by passing "Securities Litigation Uniform Standards Act" ("SLUSA") which set out to amend the '33 Act and made federal courts the exclusive venue for most securities class action filings. It was subsequently challenged by a string of lawsuits.

On March 20, 2018 in *Cyan,* the Supreme Court essentially rolled back the SLUSA protections, ruling that securities plaintiffs could bring class actions under the '33 Act in state courts.

***Cyan's* effect**

Why does *Cyan* matter? At Risk Strategies, we're already seeing a profound economic impact of *Cyan* on clients in the cost of public D&O insurance. The following example has been altered to protect privacy, but demonstrates the real-world numbers we're seeing.

Earlier this year, for a company preparing to go public in Q1, we were able to negotiate a premium price of $340,000 on the primary layer of a $100 million+ D&O program, with a $1.5 million deductible. Generally, policies of this size are underwritten by multiple insurers to spread risk in what's called a "public tower." The public tower was to be written in layers of $10 million, with each subsequent layer costing a percentage of the first $10 million of coverage.

For reasons beyond the company's control, the IPO was delayed. *Cyan* came out on March 20. By June and July, lawsuits were being filed in several different states at a frightening pace. By the time of our client's IPO in Q3, the cost for the same insurance was raised to $500,000 with a $2.5 million deductible.

To make matters worse, underwriters are hesitant to put out layers of $10 million to build the public tower. The new norm, thanks to *Cyan*, is $5 million layers. Brokers may well face building and negotiating D&O towers with a lot more insurers to execute $100 million plus program structures.

So, what can public companies do in the age of *Cyan* to mitigate their litigation exposure? Stay tuned. We'll cover that next week in our blog, *"Mitigating Risks from Cyan."*

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