Defense Strategies under the Securities Act

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This practice note provides strategies to defeat securities fraud claims ***under*** Section 11 (*15 U.S.C. § 77k*) of the ***Securities Act*** of 1933, as amended (***Securities Act***). Section 11 imposes strict liability on issuers and signatories and negligence liability on underwriters if, at the time a registration statement became effective, the statement either contained an untrue statement of a material fact or omitted to state a material fact required to make the registration statement not misleading. A plaintiff must show that it purchased securities in the offering or securities traceable to the offering. This note maps ***defense strategies*** including (1) investigating a securities fraud complaint when it is filed and initial steps, (2) coordinating multiple complaints filed in state and federal courts, (3) preparing motions to dismiss, (4) discovery and expert witnesses, (5) challenges to class certification, (6) potential motions for summary judgment, and (7) preparing for trial.

For substantive elements of a securities fraud claim ***under*** Section 11 and the available defenses, see *Liability **under** the Federal Securities Laws for Securities Offerings*, *Liability for Securities Offerings Checklist*, and *U.S. Securities Laws*.

For additional information on liability provisions and potential defenses ***under*** the federal securities laws, see ***Securities Act** and Exchange Act Liability Provisions*, *Section 11 Elements and Defenses **under** the **Securities Act***, *Section 12(a)(2) Elements and Defenses **under** the **Securities Act***, *Control Person Liability*, *Reliance in Securities Fraud Actions*, *Materiality in Securities Fraud Actions*, *Scienter Defenses in Securities Fraud Actions*, *Special Litigation Committees*, *Securities Litigation **under** the Private Securities Litigation Reform Act (PSLRA)*, *U.S. Supreme Court Securities Litigation Decisions*, *Jurisdictional Defenses **under** the Exchange Act*, and *Jurisdictional Defenses **under** the **Securities Act***.

Initial Steps in Responding to a Section 11 Complaint

When a Section 11 complaint is first filed, defense counsel should take a number of initial steps. The most important is to preserve potentially relevant documents, especially electronic documents, and to issue a document preservation notice. Although the Private Securities Litigation Reform Act (PSLRA) stays discovery pending resolution of the motion to dismiss, the PSLRA specifically requires preservation of evidence. See 15 U.S.C. § 77z-1(b)(1) and (2).

Section 11 lawsuits typically name as defendants the issuer, its directors, signatories to the offering documents, and the underwriters. The issuer and its officers and directors are typically represented by one law firm and the underwriters represented by another. Most underwriting agreements require the issuer to indemnify the underwriters. Because the issuer and the underwriters often have overlapping defenses (with the underwriters having additional due diligence defenses), defense counsel for the issuer and for the underwriters often coordinate their defenses. Counsel should ensure that any relevant insurers are notified of the claims.

Often, multiple complaints are filed in both state and federal court, usually in the state where the issuer is headquartered. To the extent possible, these cases should be coordinated, as discussed in the next section below. Counsel should collect the relevant offering documents and the issuer's public filings to begin preparing arguments for potential motions to dismiss, as well as conduct preliminary interviews of key witnesses.

Coordinating Multiple Complaints Filed in State and Federal Courts

In *Cyan, Inc. v. Beaver Cty. Emples. Ret. Fund, 138 S. Ct. 1061 (2018)*, the Supreme Court held that class action lawsuits asserting claims ***under*** the ***Securities Act*** filed in state court cannot be removed to federal court. As a result, defendants often face multiple lawsuits in state and federal courts. While the federal suits can be consolidated and a lead plaintiff appointed pursuant to the provisions of the PSLRA (i.e., 15 U.S.C. § 77z-1(a)(3)), it is not possible to consolidate the state court actions with the federal court actions, or to consolidate lawsuits filed in different states.

It may be possible to avoid litigating ***Securities Act*** claims in state court if the company's charter or bylaws has a forum selection clause that requires such claims to be filed in federal court. Courts in Delaware, New York, Utah, and California have enforced such federal forum provisions and dismissed state court actions. See *Salzberg v. Sciabacucchi, 227 A.3d 102 (Del. 2020)*; *Hook v. Casa Sys., Inc., 2021 N.Y. Misc. LEXIS 17448, at *8 (N.Y. Sup. Ct. Aug. 30, 2021)*; *Volonte v. Domo, Inc., 2023 UT App 25, 528 P.3d 327*; *Wong v. Restoration Robotics, Inc., 78 Cal. App. 5th 48, 79–80, 293 Cal. Rptr. 3d 226, 251 (2022)*, review denied (July 27, 2022).

If the case must remain in state court, it may be possible to seek a stay of later-filed cases in favor of earlier-filed cases. Some state courts have granted stays in parallel actions, particularly when the federal suit is commenced first and the state suit is wholly duplicative or is not viable. See, e.g., *Matter of Qudian Sec. Litig., 2018 N.Y. Misc. LEXIS 5447, at *4 (N.Y. Sup. Ct. Nov. 14, 2018)*; *Lowinger v. Solid Biosciences, Inc., 2018 Mass. Super. LEXIS 95, at *4 (Mass. Super. Ct. June 24, 2018)*. But state courts are not obligated to stay parallel actions, and state courts have denied motions to stay parallel actions, especially when the state suit was filed before the federal suit. See, e.g., *Matter of Dentsply Sirona, Inc. Shareholders Litig. v. XXX, 2019 N.Y. Misc. LEXIS 4260, at *14 (N.Y. Sup. Ct. Aug. 02, 2019)*.

When litigating Section 11 claims in state court and drafting motions, you should keep in mind that state courts may not be as familiar with securities laws issues as federal courts. Moreover, many states' motion to dismiss practice is not as robust as the federal practice, and it is sometimes necessary to educate state court judges regarding the rigor that should be applied to reviewing the adequacy of pleading claims ***under*** the federal securities law. Finally, some, but not all, states apply the PSLRA stay of discovery pending motions to dismiss, and this issue may need to be litigated in the state court forum.

Preparing a Motion to Dismiss

Motions to dismiss ***Securities Act*** claims (such as claims ***under*** Section 11) are more difficult to win than motions to dismiss claims ***under*** the Securities Exchange Act of 1934, as amended (Exchange Act) (such as claims ***under*** Section 10(b) (*15 U.S.C. § 78j*)), because ***Securities Act*** claims generally do not require the plaintiff to show that:

- It relied on the relevant registration statement
- The misstatement or omissions caused its losses
- The defendant had a culpable state of mind (also known as scienter)

See *N.J. Carpenters Health Fund v. Royal Bank of Scot. Grp., PLC, 709 F.3d 109, 120 (2d Cir. 2013)*.

Although Section 11 provides a low bar for liability, there are a number of statutory defenses to Section 11 claims, including:

- A one-year statute of limitations (*15 U.S.C. § 77m*)
- A three-year statute of repose (*15 U.S.C. § 77m*)
- The defendants' due diligence (not applicable to the issuer)
- A showing that other factors caused the plaintiff's losses (the negative causation defense) (*15 U.S.C. § 77k(e)*)

- Plaintiff's actual knowledge of specific untruth or omissions

In addition to these statutory defenses, there are other arguments defendants can raise in a motion to dismiss:

- **Statements do not give rise to liability.** The alleged misrepresentations or omissions are one of the following:
    - ○ Not material
    - ○ Forward-looking statements that are protected by the PSLRA safe harbor (*15 U.S.C. § 77z-2*). It should be noted that the PSLRA safe harbor does not apply to IPOs, but rather only to issuers that are already subject to Exchange Act reporting requirements. (*15 U.S.C. § 77z-2(a)(1)*. The judicially-developed bespeaks caution doctrine, which pre-dated the enactment of the PSLRA, also provides that forward-looking statements accompanied by meaningful cautionary language are not actionable and may be used in situations where the PSLRA does not apply, such as an IPO.
    - ○ Statements of opinion that are not actionable ***under*** *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318 (2015)*, which limited the scope of liability for opinion statements. See *In re Phillip Morris Int'l Inc. Sec. Litig., 89 F.4th 408, 409 (2d Cir. 2023)* (holding that defendant's statements that its "studies were 'conducted according to Good Clinical Practice ('GCP')'" were inactionable opinions ***under*** Omnicare.).
- **Negative causation.** On the face of the complaint, the allegations demonstrate that the alleged misrepresentations or omissions did not cause the plaintiff's damages (the negative causation defense), such as when the stock price drops prior to the corrective disclosure.
- **Not traceable to offering.** Plaintiff cannot demonstrate that it purchased shares in the offering or traceable to the offering, such as when plaintiff purchases shares in the secondary market and there are other shares in the market that are not traceable to the offering at issue, such as founders' shares, employee benefit plan shares, or shares issued in a secondary offering.

Although some of these arguments may raise fact questions that cannot be resolved on a motion to dismiss, often the facts necessary to establish these defenses appear on the face of the complaint, combined with the issuer's Securities and Exchange Commission (SEC) filings and stock price, which the court can judicially notice when ruling on a motion to dismiss. If the motion to dismiss is not successful, defendants can re-urge these arguments after discovery on a motion for summary judgment or at trial.

Discovery and Expert Witnesses

Counsel should develop trial themes during discovery based on the expected jury instructions and the factual record, which will also help guide the development of evidence during discovery.

Discovery from the plaintiff is often useful to:

- Challenge the plaintiff's adequacy as a class representative ***under*** *Federal Rules of Civil Procedure (FRCP) 23(a)(4)*
- Seek to establish affirmative defenses such as whether the plaintiff had actual knowledge of the falsity of the alleged misrepresentations or omissions

Both plaintiffs and defendants typically employ expert witnesses to opine on the materiality of the alleged misrepresentations or omissions and calculate alleged damages. Defendants often engage experts witness to:

- Show that plaintiff cannot trace its shares to the offering
- Establish the negative causation defense by demonstrating that the alleged misrepresentation or omissions did not cause plaintiff's losses

In addition, underwriter defendants often employ expert witnesses to establish the adequacy of due diligence.

Challenges to Class Certification

There are a number of potential challenges to class certification, including:

- **Standing.** The named plaintiff lacks standing (an argument typically first raised in a motion to dismiss) because the named plaintiff either:
    - Did not purchase or sell securities during the initial public offering
    - Made an aftermarket purchase but cannot trace the shares to the allegedly misleading registration statement
- **Lack of injury.** The named plaintiff did not suffer any injury and brings claims based solely on the economic loss of unnamed class members (including where the named plaintiff did not personally purchase a security from each relevant offering or tranche).
- **Class definition.** In courts that consider the injuries of absent class members and refuse to certify classes in which absent members lack standing, argue that the class definition purports to include plaintiffs that did not suffer any discernable injury or purchased different securities with unique characteristics.
- **Methodology for damages.** Plaintiff failed to demonstrate commonality, typicality, adequacy, and predominance because plaintiff failed to offer a theory or methodology for demonstrating and quantifying the class plaintiffs' losses ***under*** Section 11's damages formula. *15 U.S.C. § 77k(e)*.
- **Actual knowledge of certain class members.** Individualized inquiries may preclude class certification if the defendant can assert an actual knowledge defense against putative class members who either:
    - May have known about the falsity of the statement during the acquisition, based on that plaintiff's individual communications or widely known information exposing the untruth or omission
    - Had more than a mere awareness of the risk that an issuer may have made a mistake or included potential inaccuracies in the registration statement
- **Reliance.** Individualized inquiries may preclude class certification if defendants can establish a defense against the presumption of reliance. Putative class members must show that they relied on the alleged material misstatements or omissions if the issuer released an earning statement covering a period of at least 12 months beginning after the effective date of the registration statement and plaintiffs acquired their securities after the issuer made the earning statement available to the public in an SEC filing. *15 U.S.C. § 77k(a)*.

Potential Motions for Summary Judgment

If the arguments outlined above are not successful at the motion to dismiss or class certification stage, they can be reasserted on a motion for summary judgment. Materiality is often considered a question of fact, which often precludes granting a motion to dismiss. Materiality can often be decided at the summary judgment stage, however, bolstered by facts gleaned in discovery and the use of expert opinions. As discussed in greater detail below, the negative causation defense is fact specific and usually requires an expert opinion to establish. This defense is also appropriate for a motion for summary judgment. The actual knowledge of certain class members and individual reliance are also often fact specific inquiries and more appropriate for a motion for summary judgment than a motion to dismiss.

Trial Considerations

Since the passage of the PSLRA in 1995, thousands of securities fraud lawsuits have been filed, but only approximately 30 of them have gone to trial. *1 Litigating Securities Class Actions § 5.01* (Matthew Bender & Co.). Despite the low probability of any particular securities action making it to trial, it is important to think about trial preparation during all phases of the case, including:

- Potential trial themes

- The factual presentation of each side's case
- The use of experts
- Damages issues

Potential Trial Themes

As noted above, counsel should develop trial themes during discovery based on the expected jury instructions and the factual record, which will also help guide the development of evidence during discovery. Although the themes must be tailored to the facts of the case, defendants usually emphasize they worked hard to ensure that all relevant disclosures were made, that the market had sufficient information to value its stock, and that the company managed its business well. Even though scienter is not an element of a Section 11 claim, defendants typically argue that they made the best decisions that they could make in good faith, with the information available at the time, and that plaintiffs' claims are based on hindsight. Where defendant asserts a negative causation defense, defendants also argue that market events or other external factors caused the issuer's stock price to fall, not the alleged misrepresentations or omissions.

In complex cases such as securities class actions, it is often useful to conduct focus groups and mock trials to (1) test trial themes, jury perception of witnesses, and important documents; (2) evaluate the best method of presenting complex facts and ideas, including demonstrative exhibits; and (3) determine the profiles of ideal jurors to assist with voir dire.

Motions in limine to exclude certain evidence should be considered well before trial. For example, plaintiffs may seek to introduce evidence of corporate wrongdoing that is unrelated to the securities offering at issue, and defendants should be prepared to seek to exclude such evidence.

Another important consideration is whether to bifurcate the trial into separate liability and reliance or damages phases. Courts often, but not always, bifurcate securities fraud class action trials.

Factual Presentation of Each Side's Case

Both plaintiff and defendant must determine the best way to present information with the most effective witnesses and the most compelling documents. Demonstrative exhibits are often helpful. Defendants must determine the best approach to plaintiffs who serve as witnesses, depending upon whether the plaintiff is an individual or an institutional investor. In addition to seeking to establish affirmative defenses such as actual knowledge or lack of reliance (where relevant), examination of plaintiffs can often be used to establish the plaintiff's diligence and sophistication (or lack of it) and whether plaintiff viewed certain information or risk disclosures as material or relevant. Choose defense witnesses carefully to ensure they are knowledgeable and can offer helpful evidence, and consider whether they will be viewed as credible or likable by the jury.

Use of Experts

As noted above, expert witnesses play a large role in complex securities cases, especially with respect to tracing and damages calculations. Plaintiffs' (and the absent class members') inability to trace their shares to the offering at issue is a powerful way to reduce class-wide damages. Expert witnesses can also be used to summarize certain facts and evidence, but it is often more compelling for the facts to be presented by representatives of the company and the underwriters, as opposed to expert witnesses.

Damages and Causation Issues

Section 11(e) limits the damages available 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

    - ***Under*** this prong of the formula, if the plaintiff has sold their shares pre-suit for more than the offering price, they have no conceivable statutory damages—even though they may have lost money on the investment. *In re Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 296*.
- 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. For plaintiffs who did not sell their securities prior to suit, the maximum recovery is the difference between (1) the purchase price (if not greater than the offering price) and (2) whichever of the following yields the lesser amount of damages: (a) the value of the security at the time of suit or (b) the amount received by the plaintiff in any sale of the securities during the pendency of the suit. *15 U.S.C. § 77k(e)(1), (3)*; *In re Cendant Corp. Litig., 264 F.3d 201, 228* & n.8. Thus, the maximum recovery is frozen at the time of suit at the offering price less the value of the security on that day. *Beecher v. Able, 435 F. Supp. 397, 410 (S.D.N.Y. 1975)*. Post-suit declines are not recoverable. Although courts have held that the value of the security on the day of suit is not necessarily synonymous with its market price, courts have also opined that the market price is the presumptive value. See, e.g., *McMahan & Co. v. Wherehouse Entertainment, 65 F.3d 1044, 1048–49 (2d Cir. 1995)*. Accordingly, where the market price on the day of suit was equal or greater to the offering price, defendants should move to dismiss because there are no conceivable statutory damages.

Even if a motion to dismiss based on lack of damages ***under*** the statutory formula fails, defendants can often establish a negative causation defense on a motion for summary judgment or at trial by demonstrating that factors other than the alleged misrepresentations or omissions caused the issuer's stock price to fall. *15 U.S.C. § 77k(e)*. This is especially true where the stock price falls prior to any corrective disclosure is made or where industry-wide events cause stock prices of similarly situated companies to fall. This defense is generally established with expert witnesses who prepare event studies that correlate disclosures in the market with the issuer's stock price movement. An event study is an empirical statistical analysis by which experts may "disentangle[ ] the effects of two types of information on stock prices—information that is specific to the firm ***under*** question . . . and information that is likely to affect stock prices marketwide." *In re Vivendi, S.A. Sec. Litig., 838 F.3d 223, 253* (quoting Mark L. Mitchell and Jeffry M. Netter, The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities & Exchange Commission, *49 Bus. Law. 545, 556–57 (1994)*). See also *Askelson v. Freidus (In re Barclays Bank PLC Sec. Litig.), 756 F. App'x 41* (affirming summary judgment dismissing Section 11 claims based on negative causation affirmative defense established by expert's event study). Event studies are more useful to determine the materiality of misrepresentations as opposed to omissions because the studies can be used to demonstrate the positive (or lack of positive) impact of the disclosure of fact on the price of the company's stock.

Practical Considerations

As soon as you, as defense counsel, receive a Section 11 complaint, you should begin mapping a ***defense strategy*** that can guide all phases of the case from initial case assessment and document preservation, to motions to dismiss and summary judgment, and trial. This roadmap should include the following:

- Take initial steps to preserve potentially relevant documents and notify insurers of claims.
- Determine how best to coordinate multiple federal and state lawsuits.
- Collect relevant SEC filings and public statements and begin to analyze bases for a potential motion to dismiss, including:
    - Statute of limitations
    - Lack of standing
    - Failure to allege material misrepresentations or omissions (including forward-looking statements protected by PSLRA safe harbor or opinion statements that are not actionable ***under*** *Omnicare*)
    - Absence of statutory damages
- Develop trial themes (which should be further developed in discovery), such as the following:

- ○ Defendants worked hard to ensure that all relevant disclosures were made.
- ○ The market had sufficient information to value its stock.
- ○ The company managed its business well.
- ○ Defendants made the best decisions that they could make in good faith, with the information available at the time.
- ○ Plaintiffs' claims are based on hindsight.

- Consider which defenses can be re-urged in opposition to class certification in a motion for summary judgment if the motion to dismiss is denied.
- Retain appropriate expert witnesses early to provide opinions on materiality and causation, as well as any other issuer-specific issues that may be helpful.

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