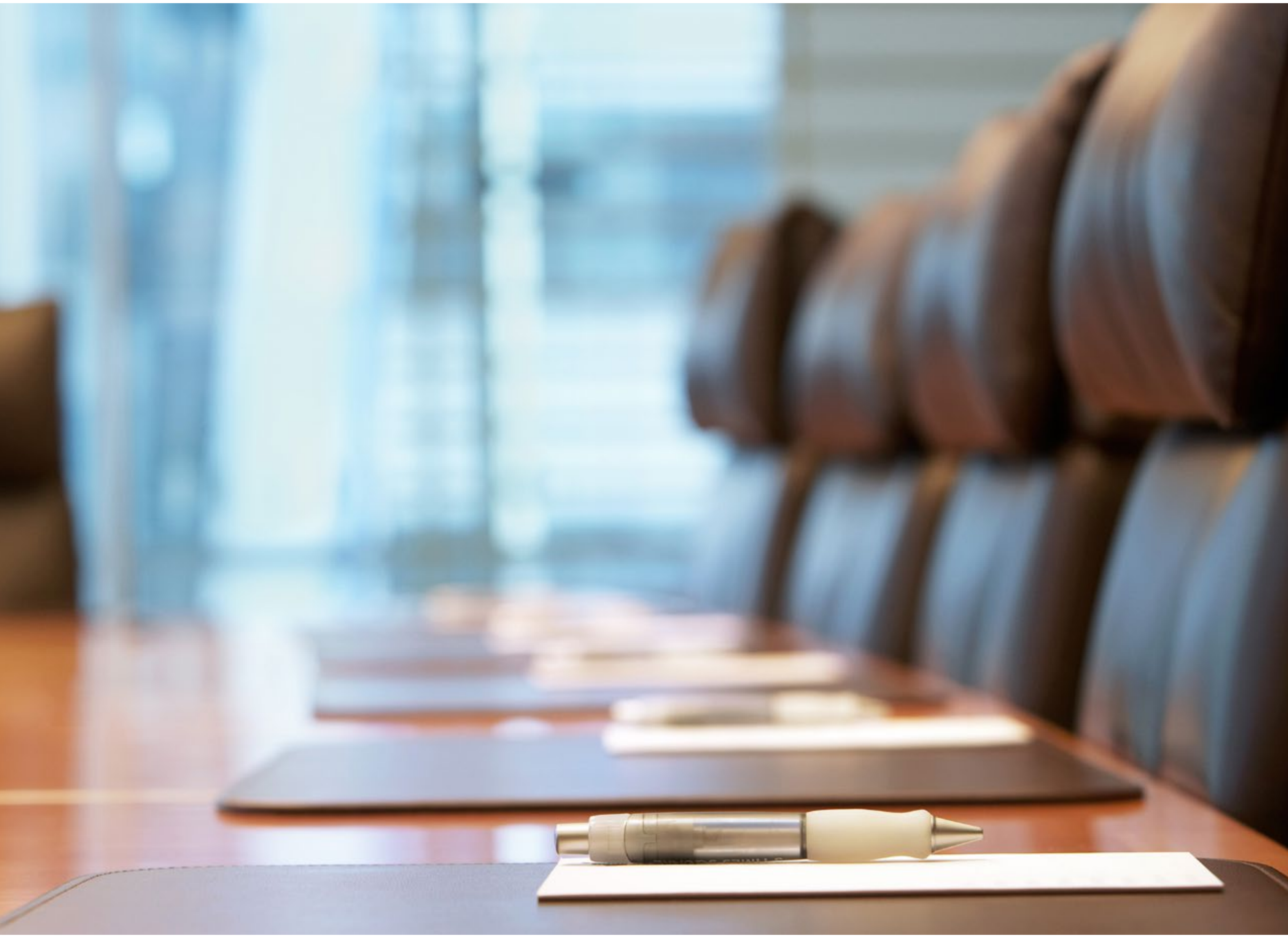

Current Developments in Shareholder Litigation in California

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The dominant features in the shareholder litigation environment in California today are fragmentation and uncertainty:

- Plaintiffs' bar fragmentation means 'too small to sue' no longer applies
- Uncertainty as to whether IPO lawsuits can be brought in state court or only Federal
- Uncertainty in the evolution of merger and fiduciary duty suits
- Uncertainty as to the strength of the Safe Harbor for forward-looking statements
- Uncertainty as to the evolving risk profile for private companies, which historically were less concerned about shareholder lawsuits

Fragmentation

For decades, a handful of prominent plaintiffs' law firms dominated securities litigation throughout the United States. This was particularly true in California. The influence of such firms has diminished substantially in recent years. Smaller firms have dramatically increased their market share. This development has several implications for shareholder suits.

One implication is that the threshold for bringing a suit seems to have dropped precipitously. Historically, some companies were considered "too small to sue." That is no longer the case. We have seen securities suits filed against mid-cap, small-cap, and even micro-cap companies, particularly in fields such as life sciences, biotech and pharma. As the number of active competitors in the plaintiff market has grown, some firms — particularly less well-funded and smaller ones — have begun filing cases that would not have been deemed worthwhile before. Not surprisingly, this has contributed to the substantial increase in the frequency of shareholder class actions. In just the first half of 2017, plaintiffs' firms filed 226 new Federal shareholder class actions; a 135 percent above the average filing rate over the prior 20 years.*

Another implication is that the quality of many of the suits has declined. As more firms are filing cases that the major firms would have likely passed on, the alleged misstatements often seem more tenuous. This has led to a higher rate of dismissal on the pleadings. On the other hand, the filing of these suits by smaller firms builds their experience level and still costs the companies substantial sums in defense costs. At the time that you purchase your D&O insurance, you don't know what type of firm might bring a future suit against you.

We turn now to four different categories of exposure to assess the current state of play in California shareholder litigation.

* Securities Class Action Filings – 2017 Midyear Assessment, Cornerstone Research

IPO Lawsuits

The dominant issue in suits brought under Section 11 of the Securities Act of 1933 is: "which court?" For the first few years after going public, companies face the threat of a Section 11 suit — alleging material misstatements or omissions in the registration statement and prospectus — if the trading price drops below the IPO price. Historically, plaintiffs filed those suits in Federal court. Over time, Federal courts became increasingly willing to toss out those suits at the motion to dismiss stage, on the ground that the allegations failed to meet the requisite pleading standard.

In the last few years, plaintiffs' firms have shifted many of those suits to state courts, especially in California. It is much harder to get a state court to dismiss a meritless Section 11 suit than it would be to win in Federal court — even though both systems are supposed to apply Federal law. The pleading rules in state court are often more lenient to plaintiffs than the Federal rules. Moreover, Federal judges are often inured to rote allegations of fraud, which they see in shareholder suit after shareholder suit. By contrast, some state judges are less skeptical of plaintiffs' accusations.

A major split has developed between courts in New York and in California: the former generally allow Section 11 suits to be removed to Federal court, while the latter generally do not. The U.S. Supreme Court has recently agreed to resolve this matter, in the case of *Cyan, Inc. v. Beaver County Employees Retirement Fund* (No. 15-1439). A decision is likely by mid-2018. A victory for the company in that case likely would lead to fewer Section 11 suits overall and to more dismissals of suits brought in Federal court instead of state. On the other hand, a victory for plaintiffs could lead to even higher filing rates for IPO suits.

Until the Supreme Court rules, companies in California that have experienced a post-IPO stock price drop are waging many procedural battles over what should happen to the state cases pending the Supreme Court's decision.

A related, but distinct, issue will be whether companies can specify in their articles of incorporation or bylaws that shareholders may file Section 11 suits only in Federal court. Organizational documents for companies in a few recent IPO's have contained such provisions. Their validity has not yet been definitively resolved, although litigation is already under way. If the company wins in Cyan, then the issue will be moot. But if the plaintiffs win in Cyan, then such provisions are likely to become much more common for companies going public. The issue of their validity will likely spawn substantial litigation.

Merger Lawsuits

At the other end of the corporate lifecycle from birth is death: being acquired. Boilerplate, meritless shareholder suits challenging mergers had become a near-certainty of corporate life in California. That has begun to change somewhat, due to two developments.

The first was the widespread adoption of "Delaware only" forum selection clauses in corporate bylaws. Many corporations, especially in California, adopted provisions requiring suits alleging breach of fiduciary duty to be brought in the Delaware Court of Chancery (for business incorporated in Delaware). Such clauses have repeatedly been upheld and enforced. The forum selection statute applies only to lawsuits that assert "internal Corporate claims" such as shareholder derivative suits. The applicability of the statute has been especially common in the context of merger litigation.

A second development was Delaware's gradual rejection of disclosure-only settlements. Until recently, the typical course of a merger suit was as follows: the plaintiff would claim that the proxy statement or tender offer documents in connection with a merger omitted necessary information; the company would issue supplemental disclosures (often of a trivial nature); and the defendants would then pay the plaintiffs' lawyers a fee for "the benefit conferred upon the shareholders." Judges in Delaware grew skeptical about the actual value of such settlements, especially since the defendants were receiving an "intergalactic" release in return and started criticizing and even rejecting them. This culminated in the decision in *In re Trulia Shareholder Litigation,* 129 A.3d 884 (Del. Ch. 2016). That case held that, going forward, the Court of Chancery would approve a disclosure settlement only if the supplemental disclosures were undoubtedly material, and even then, the release given to defendants would be limited to disclosure issues. State courts in California recently have begun to apply Trulia to their merger suits as well.

In search of greener pastures, some plaintiffs' firms have now moved to Federal court. They cast their disclosure claims as violations of the Federal proxy or tender offer statutes. This is ironic, given that plaintiffs' lawyers historically have gone to great lengths to avoid Federal court and stay in state court.

These Federal merger suits are still in flux. For some firms, the preferred path is to file the suit, have the company moot it with supplemental disclosures, and then collect a "mootness fee." This is not a settlement per se and therefore is not thought to require judicial approval. It remains to be seen whether Federal judges will intervene to express disapproval of this phenomenon, as the Delaware Court of Chancery judges did.

Still other firms file suit in a state other than Delaware that is not generally perceived to be a prominent venue for securities litigation. Even if the corporation has an exclusive forum bylaw, unless it affirmatively moves to enforce that bylaw, the parties are free to enter into a disclosure-only settlement and seek to have the court of the forum state approve the settlement and grant the company an "intergalactic" release.

Some of the Federal merger suits have not settled and are now being litigated. It is too early to draw firm conclusions on how these suits will play out. Preliminary indications are that many of these suits will be dismissed. If that holds true over time, then the settlement value of such cases will decline, and enterprising plaintiffs' lawyers will have to go back to the drawing board. It may be that they go back to California state court and challenge the Delaware venue provisions in a more robust manner than they have to date.

Forecasting Cases

In the long space between IPO and acquisition is the operating life of the public company. Historically, the greatest threats to companies in the securities litigation context have been financial restatements and "missed quarter" cases. With respect to accounting cases, the law and practice has been relatively stable for some time.

With respect to "missed quarter" cases — where a company announces that its quarterly results have fallen below guidance, triggering a stock drop and shareholder suits — things may be changing on the West Coast. Since Congress enacted the Safe Harbor provisions in the Private Securities Litigation Reform Act of 1995, companies have felt relatively protected in providing transparent guidance to the Street. Taken together with the SEC's promulgation of Regulation FD (which outlawed back-room, selective guidance to securities analysts), the dominant paradigm became public guidance as to future results, protected by the Safe Harbor.

A recent decision by the U.S. Court of Appeals for the Ninth Circuit (which governs California) might shake things up. *In Re Quality Systems, Inc. Securities Litigation,* No. 15-55173 (9th Cir. July 28, 2017) reversed the district court's dismissal of a securities fraud suit. The decision's analysis of various aspects of the Safe Harbor was hostile in both tone and application, particularly when compared to many prior forecasting decisions. The particular panel is one perceived as more receptive to plaintiffs than others on the Court, so this could be a one-off decision. But if Quality Systems really becomes the law in the Ninth Circuit, it is likely to spawn many more missed-quarter cases than have been filed in recent years, and make it harder to get them tossed.

Private-Company Shareholder Suits

Traditionally, shareholder litigation was not viewed as a major threat for pre-public companies. This has changed recently. Perhaps as a result of the emergence of so many "unicorns" in Silicon Valley, the amounts at stake in governance disputes at private companies have increased many-fold. In several high-visibility cases, large investors — including venture capital firms — have filed fraud and breach of fiduciary duty suits. Given how areas of litigation evolve, this phenomenon may well spread even to lower-capitalized private companies. Moreover, the SEC – which historically has focused much more on public companies – has recently started to take a harder look at disclosure issues at private companies. These developments suggest that private companies would be well-advised to rethink their approach to D&O insurance, which historically has not received much attention in the context of potential shareholder litigation prior to the IPO.

Directors at companies in California need to be intimately involved in the process of obtaining D&O insurance policies. Rather than leaving it to budgetary pressures, directors should probe the types and amounts of coverage that they purchase to make sure that, if a suit hits, they will be adequately protected.

About the author

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Boris Feldman specializes in securities litigation and federal appellate work. He has defended more than 200 shareholder class actions, derivative suits, and merger challenges around the country, and has handled over 50 appeals in federal and state courts. Boris also represents audit committees and boards of directors in internal investigations and represents companies and individuals in SEC-enforcement proceedings around the country. He regularly advises public companies on fiduciary duty and disclosure issues.

During his 30 years in Silicon Valley, Boris has represented many of the leading companies in the technology world, including Google, Facebook, Genentech, Netflix, Salesforce, and Hewlett-Packard. In addition, the individuals he has represented comprise an honor roll of innovators and entrepreneurs, including Marc Andreessen, Carol Bartz, Eric Benhamou, Marc Benioff, Herb Boyer, Sergey Brin, Vint Cerf, John Doerr, Carly Fiorina, John Hennessy, Steve Jobs, Arthur Levinson, Ray Noorda, Larry Page, Ross Perot, Eric Schmidt, Al Shugart, Robert Swanson, and Mark Zuckerberg.

Boris has been at Wilson Sonsini Goodrich & Rosati in Palo Alto since 1986. Among other leadership roles, he has served as a member of its board of directors and chair of the firm's Policy Committee.

Boris has served as a lawyer-representative to the Ninth Circuit Judicial Conference, a member of the Ninth Circuit's Lawyer Representative Coordinating Committee, and co-chair of the lawyer representatives to the Northern District of California. He is an elected member of the American Law Institute.

Boris also was a member of the six-person advisory committee established by the U.S. District Court for the Northern District of California to propose modifications of the Local Rules in light of the Private Securities Litigation Reform Act of 1995. Boris testified before the Senate Banking Committee on the Securities Litigation Uniform Standards Act. He was appointed to a blue ribbon panel to propose changes in the California shareholder laws and was a member of the Santa Clara County Superior Court Task Force on Complex Litigation.

From 1985 to 1986, Boris served as special assistant to the legal adviser at the U.S. Department of State. Prior to that, he had spent four years as an associate at Arnold & Porter in Washington, D.C. He was a law clerk to Judge Abraham D. Sofaer in the U.S. District Court for the Southern District of New York from 1980 to 1981.