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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Still Divisive: PSLRA Discovery Stay

Law360, New York (March 12, 2009) -- A recurring issue in securities litigation is whether the Private Securities Litigation Reform Act automatic discovery stay should be lifted when defendants produce documents to regulators, prosecutors or other litigants not bound by the stay and the plaintiffs seek access to those documents.

The circuit courts have not yet provided any specific guidance as to this issue. The district courts have reached starkly differing conclusions.

Indeed, within just the past few months, in two of the auction rate securities cases involving precisely the same circumstances and based on exactly the same arguments, one court denied a request to lift the discovery stay while another in the same district reached the opposite conclusion and granted a motion to lift the stay.

If parallel U.S. Securities and Exchange Commission, Department of Justice and private litigation proceedings were not sufficiently difficult already, the inconsistent district court approaches to requests for relief from the discovery stay to provide plaintiffs access to documents defendants have been required to produce to regulators raises yet another serious concern to which counsel must pay attention.

The PSLRA Discovery Stay

Congress passed the PSLRA to curb “abusive practices committed in private securities litigation.”[1] Among its other reforms, the PSLRA imposed heightened pleading requirements and mandated an automatic stay of discovery during the pendency of any motion to dismiss.[2]

While the stay is in effect, a defendant is required to treat all documents in its custody or control relevant to the allegations in the complaint as though they were subject to a continuing request for production under the Federal Rules of Civil Procedure.[3]

The discovery stay reflects Congress' determination that complaints in securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than on information produced by the defendants after the action has been filed.[4]

The courts must make an initial assessment of the legal sufficiency of any claims in securities litigation before allowing discovery to commence.[5]

The PSLRA permits a plaintiff to move for an order lifting the discovery stay prior to the resolution of a motion to dismiss, but to succeed with that motion a plaintiff must demonstrate that its discovery request is "particularized," and that lifting the stay is necessary either to "preserve evidence" or to avoid "undue prejudice" to the plaintiff.[6]

Congress did not intend this to be an easy test to meet. The courts have described the plaintiff's burden as a "heavy one," as exemplified by the fact that the sole example proffered in the congressional reports as justifying a lifting of the stay is the terminal illness of an important witness whose testimony may become unavailable if not taken prior to a ruling on the motion to dismiss.[7]

The question that has divided the courts is how the requirements for lifting the stay should be applied when a defendant already has responded to government investigations and has produced relevant documents to regulators, prosecutors, or even other litigants not bound by the PSLRA discovery stay.

Making another copy of documents that already have been produced to others may require only a relatively slight additional effort on the part of a defendant in a typical situation. Does that mean that the purposes the PSLRA discovery stay was intended to serve are not implicated by a request to lift the stay when documents already have been produced to regulators?

According to plaintiffs, lifting the discovery stay in the context of parallel discovery proceedings, when the documents already have been produced to others, would place plaintiffs on an equal footing with others seeking remedies for the same alleged wrongdoing. Should that be reason enough to lift the discovery stay?

Plaintiffs have argued that there is no reason not to lift the discovery stay when all they seek are the documents a defendant already has produced to others not bound by the stay.

In many, if not all instances, however, that argument has failed, and the courts have declined to lift the discovery stay, but there can be no certainty as to the outcome in particular cases.

In at least one case a court of appeal has explained that the stay may not be lifted to make available to plaintiffs discovery that will help them frame sustainable complaints.[8]

The circuit courts, however, have not specifically addressed the circumstances presented when a defendant already has produced relevant documents to regulators and others, and the issue therefore remains uncertain. The district courts accordingly have reached directly inconsistent results.

The Auction Rate Securities Cases

Recent decisions in two of the auction rate securities cases evidence the differing approaches among the district courts. These decisions are noteworthy because they were rendered within two months of each other, they involved the same circumstances and they considered the same arguments, but they reached exactly opposite conclusions.

In the first, the court denied the plaintiffs' motion to lift the PSLRA discovery stay. In re UBS Auction Rate Sec. Litig., No. 08 Civ. 2967 (LMM), 2008 WL 5069060 (S.D.N.Y. Nov. 21, 2008) ("UBS").

In the second, the court granted the plaintiffs' motion. Waldman v. Wachovia Corp., No. 08 Civ. 2913 (SAS), 2009 WL 86763 (S.D.N.Y. Jan. 12, 2009) ("Wachovia").

The plaintiffs in both cases were purchasers of auction rate securities who claimed that the defendants had marketed those securities by means of material misrepresentations and omissions and market manipulation.

In both instances the defendants had been investigated by the SEC as well as state and industry regulatory authorities, and in both instances they also had been named as defendants in various other civil litigations not subject to the PSLRA discovery stay.

Both defendants had produced large volumes of documents and testimony to the regulators, and both defendants had entered into settlements with the regulators.

In both cases, before the securities complaints were tested on a motion to dismiss, the plaintiffs moved for a partial lifting of the PSLRA discovery stay so as to permit them to obtain the documents and the testimony the defendants had provided, or were obligated still to provide, to the regulators.

In each case, the plaintiffs, represented by the same counsel, made exactly the same arguments in support of their motions. They argued that:

- the fact of the regulatory investigations and the defendants’ settlements with the regulators demonstrated that plaintiffs' claims had merit, and the discovery they sought therefore was neither a fishing expedition nor an inappropriate attempt to use the cost of discovery to extort settlements;

- their discovery requests were sufficiently particularized because they asked only for the documents and testimony the defendants already had produced or were obligated to

produce to the regulators; no additional discovery burden was being imposed on the defendants;

- plaintiffs would be unduly prejudiced if the discovery stay were not lifted because they were the only major parties to the controversy without access to the documents and they needed those documents to evaluate the sufficiency of the settlements the defendants had reached with the regulators and to evaluate whether the plaintiffs should continue their own lawsuits despite those settlements;

- the defendants allegedly had suffered financial reversals and there was a risk that if discovery was delayed defendants would be unable to respond to any judgments ultimately entered against them;

- while there was no risk that the documents and testimony already in the hands of the regulators would be lost, lifting the stay allegedly would enable the plaintiffs to identify other documents that might not be available subsequently given the defendants' allegedly precarious financial conditions.

These arguments were summarily rejected in UBS. The court in that case denied the motion to lift the discovery stay, holding in a brief opinion that "Lead plaintiffs have not shown at this time that the discovery they seek is necessary to preserve evidence or to prevent undue prejudice to them." 2008 WL 5069060 at *1.

The outcome was completely different in Wachovia. Although the court found that the plaintiffs had not demonstrated a need to preserve evidence because the documents and testimony they sought were already in the hands of the regulators, the court granted the plaintiffs' motion in part because it concluded that plaintiffs had shown that they would be unduly prejudiced if the discovery stay was not lifted.

The prejudice would result from the fact that the plaintiffs needed to determine whether to continue with their litigation despite the settlement which the defendant had reached with the regulators, and the unavailability of the documents burdened plaintiffs' ability to make that determination. 2009 WL 86763 at *2.

In reaching that conclusion, the court weighed the fact that the discovery the plaintiffs sought would not impose a high cost on the defendant because the defendant already had found, reviewed and organized the documents for the regulators. Id.[9]

Cases Refusing to Lift the Discovery Stay

Wachovia is not only inconsistent with UBS. Many, if not all, cases in recent years have refused to lift the PSLRA discovery stay when the request to do so was based on the fact that the documents requested already had been produced to regulators.

Courts have observed, for example, that the burden on the defendant may be relevant, but whether the requested discovery would impose only a slight cost because the

defendant already had gathered the documents for the regulators is not the issue under the statute.

The PSLRA does not list the cost to the defendant as a factor to consider in deciding whether to lift the discovery stay; the statute focuses instead on the plaintiff. To lift the stay, the PSLRA requires the plaintiff to demonstrate either the need to preserve evidence or to prevent undue prejudice to him.[10]

The courts also have found that the PSLRA does not provide any categorical exception to its discovery stay for instances in which a defendant already has produced the requested documents to regulators.[11]

They have recognized instead that Congress must have been aware that SEC investigations routinely occur contemporaneously with private securities litigation.

It is unlikely, therefore, that Congress intended the PSLRA's "undue prejudice" test to be satisfied by a showing that an SEC investigation was continuing while a private litigant's discovery was stayed.[12]

Some courts also have found that merely because a plaintiff requests access to the same documents a defendant already has produced to regulators does not mean that the plaintiff has made a sufficiently particularized discovery request. The documents produced to regulators may include many that are not relevant to the securities litigation.[13]

Many courts also have rejected the proposition that a plaintiff may demonstrate undue prejudice by arguing that the discovery stay will delay his ability to develop litigation or settlement strategy. As one court explained:

Plaintiffs' inability to gather evidence for settlement negotiations or to plan a litigation strategy is not evidence of undue prejudice. "This is because 'delay is an inherent part of every stay of discovery required by the PSLRA.'" In re Smith Barney Transfer Agent Litig., No. 05 Civ. 7583, 2006 WL 1738078, at *2 (S.D.N.Y. June 26, 2006), quoting In re Initial Pub. Offering Litig., 236 F. Supp. 2d 286, 287 (S.D.N.Y. 2002).

Plaintiffs state that the question for the Court is "whether it is appropriate to force the class to wait months while motions to dismiss are briefed and decided, while other interested parties ... are reviewing these materials now." (Pl. Mem. 3.)

That, however, is not the question for the court. Whether PSLRA plaintiffs should be subjected to a discovery stay while other parties, who are bringing claims under other causes of action, are not subjected to a stay is a question for Congress, and one that Congress has answered.

Under the PSLRA, discovery in this action has been stayed. That stay does not apply to government investigations, bankruptcy proceedings, internal investigations, or non-PSLRA actions.

The discrepancy between PSLRA actions and other actions is not evidence of undue prejudice, but rather is evidence of Congress's judgment that PSLRA actions should be treated differently than other actions. This court may not second-guess that judgment. In re Refco, Inc. Sec. Litig., No. 05 Civ. 8262 (GEL), 2006 WL 2337212 at *2 (S.D.N.Y. Aug. 8, 2006).[14]

Indeed, some courts have refused to lift the discovery stay to allow plaintiffs access to documents defendants have produced to regulators because doing so posed the risk that the plaintiffs then could use the information to respond to a motion to dismiss or to amend the complaint.

That would be inconsistent with the basic purpose of the PSLRA discovery stay to ensure that a case does not proceed to discovery until after the sufficiency of the complaint is sustained.[15]

Cases Lifting the Discovery Stay

This is not to suggest that Wachovia stands alone in lifting the PSLRA stay when defendants have already produced documents to government agencies and others. There are at least several other cases from different courts that similarly have granted requests to lift the PSLRA discovery stay.

Courts that have granted motions to lift the PSLRA discovery stay appear to rely on the fact that the cost to a defendant of producing documents already produced to others is slight, and that this modest cost burden is substantially outweighed by the prejudice a plaintiff may suffer when regulatory and other non-PSLRA proceedings continue unimpeded by a discovery stay.[16]

Cases lifting the discovery stay also treat a request for the production of just those documents already produced to government regulators and others as being sufficiently particularized, on the theory that the request is for a discrete universe of documents, even if the volume is large, without considering whether all of the documents requested by the regulators in fact would be relevant to the issues in the securities litigation.[17]

And these cases often reason that since the documents requested already have been produced to others, maintaining the discovery stay in place would not serve any interest the PSLRA was designed to advance.[18]

Some of the cases lifting the stay to give access to documents already produced to others have done so in circumstances where the plaintiffs already were in active competition with non-PSLRA plaintiffs to recover from the same defendants for

essentially the same wrongdoing. That was so, for example, in the WorldCom litigation.[19]

In that instance, the defendants already had produced documents to government agencies and to the plaintiffs in related ERISA litigation and the court had ordered the securities plaintiffs and the ERISA plaintiffs to participate in coordinated settlement negotiations within a prescribed time frame.

The court lifted the stay because the securities plaintiffs would have been at a decided disadvantage in the settlement negotiations if they were the only parties without access to the relevant documents.[20]

In another case, the stay was lifted to facilitate the plaintiffs' ability to make informed litigation decisions even though coordinated settlement negotiations had not been ordered, because, as in Wachovia, the defendants already had settled with the regulators and there was what the court described as a rapidly shifting litigation landscape in which the plaintiffs needed to formulate an informed settlement strategy of their own.[21]

Conclusion

It is not easy to reconcile all of these competing decisions. In the absence of binding circuit court guidance, the district courts are free to continue to apply their own views as to the circumstances justifying relief from the discovery stay in instances when the defendant already has had to provide discovery to government regulators and others.

This means that defendants may be unable to assume that the PSLRA discovery stay will always protect them from early discovery when they are dealing concurrently with parallel government investigations. This is an issue that will continue to require careful consideration.

--By Richard Cashman, Gibson Dunn & Crutcher LLP

Richard Cashman is of counsel with Gibson Dunn & Crutcher in the firm's New York office and a member of the firm's securities litigation practice group.

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[1] H.R. Rep. No. 104-369 at 31 (1995) (Conf. Rep.)

[2] The discovery stay is codified at 15 U.S.C. §§ 77z-1(b)(1); 78u-4(b)(3)(B).

[3] 15 U.S.C. §§ 77z-1(b)(2); 78u-4(b)(3)(C).

[4] Medhekar v. U.S. Dist. Court, 99 F.3d 325, 328 (9th Cir. 1996).

[5] See Spielman v. Merrill Lynch, Pierce Fenner & Smith Inc., 332 F.3d 116, 122-23 (2d Cir. 2003); see also Podany v. Robertson Stephens Inc., 350 F. Supp. 2d 375, 378 (S.D.N.Y. 2004); Tobias Holdings Inc. v. Bank United Corp., 177 F. Supp. 2d 162, 166 (S.D.N.Y. 2001).

[6] 15 U.S.C. §§ 77z-1(b)(1); 78u-4(b)(3)(B) (discovery shall be stayed during the pendency of any motion to dismiss "unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.").

[7] In re Fannie Mae Sec. Litig., 362 F. Supp. 2d 37, 38 (D.D.C. 2005); Faulkner v. Verizon Communications Inc., 156 F. Supp. 2d 384, 402 (S.D.N.Y. 2001) (quoting S. Rep. No. 104-98, at 14 (1995), reprinted in 1995 U.S.C.C.A.N. 679).

[8] See, e.g., SG Cowen Sec. Corp. v. U.S. Dist. Court., 189 F. 3d 909, 912 (9th Cir. 1999).

[9] The court also agreed with the plaintiffs that their demands were sufficiently particularized because they were limited to the discovery the defendant already had provided the regulators. The court did not agree, however, that the plaintiffs should be allowed to request additional documents once they were allowed to examine the documents produced to the regulators. See Wachovia, 2009 WL 86763 at *1.

[10] See, e.g., In re Sunrise Senior Living Inc. Derivative Litig., 584 F. Supp. 2d 14, 17 (D.D.C. 2008); Ross v. Abercrombie & Fitch Co., Nos. 2:05 CV 0819, 0848, 0860, 0879, 0893, 0913, 0959, 0964, 0998, 1084, 2006 WL 2869588 at *2 (S.D. Ohio, Oct. 5, 2006); In re Smith Barney Transfer Agent Litig., No. 05 Civ. 7583 (WHP), 2006 WL 1738078 at *3 (S.D.N.Y. June 26, 2006).

[11] See, e.g., In re Countrywide Fin. Corp. Derivative Litig., 542 F. Supp. 2d 1160, 1181 n.29 (2008); Swartz v. Deutsche Bank AG, No. C03 1252 MJP, 2008 WL 534535 at *2 (W.D. Wash. Feb. 26, 2008); 380544 Canada Inc. v. Aspen Technology Inc., No. 07 Civ. 1204, 2007 WL 2049738 at *2 (S.D.N.Y. July 18, 2007); Sedona Corp. v. Ladenburg Thalmann, No. 03 Civ. 3120 LTS/THK, 2005 WL 2647945 at *4 (S.D.N.Y. Oct. 14, 2005); In re Odyssey Healthcare Inc. Sec. Litig., No. Civ.A.3:04-CV-0844-N, 2005 WL 1539229 at *1 (N.D. Tex. June 10, 2005); (Rampersad v. Deutsche Bank Securities Inc., 381 F. Supp. 2d 131, 133 (S.D.N.Y. 2003).

[12] See, e.g., In re Sunrise Senior Living Inc. Derivative Litig., 584 F. Supp. 2d 14, 18 (D.D.C. 2008).

[13] See, e.g., In re American Funds Sec. Litig., 493 F. Supp. 2d 1103, 1107 (C.D. Cal. 2007); In re Fannie Mae Sec. Litig., 362 F. Supp. 2d 37, 39 (D.D.C. 2005).

[14] See also 380544 Canada Inc. v. Aspen Technology Inc., No. 07 Civ. 1204 (JFK), 2007 WL 2049738 at *4 (S.D.N.Y. July 18, 2007); Kelleher v. Advo Inc., 3:06 CV 01427 (AVC), 2007 WL 1232177 (D. Conn. April 24, 2007).

[15] See, e.g., American Funds Sec. Litig., 493 F. Supp. 2d 1103, 1106 07 (C.D. Cal. 2007); In re AOL Time Warner Inc. Sec. Litig. & ERISA Litig., No. 1500, 02 Civ. 5575 (SWK), 2003 WL 21729842 at *1 (S.D.N.Y. July 25, 2003); In re Vivendi Universal SA Sec. Litig., 381 F. Supp. 2d 129, 130 (S.D.N.Y. 2003).

[16] See, e.g., Seippel v. Sidley, Austin Brown & Wood LLP, 03 Civ. 6942 (SAS), 2005 WL 388561 at *1 (S.D.N.Y. Feb. 17, 2005); In re FirstEnergy Corp. Sec. Litig., 229 F.R.D. 541, 545 (N.D. Ohio 2004); In re Enron Corp. Securities, Derivative & ERISA Litig., Nos. MDL 1446, Civ. A H 01 3624, 2002 WL 31845114 at *2 (S.D. Tex. Aug. 16, 2002).

[17] See, e.g., In re Delphi Corp. Sec., Derivative & “Erisa” Litig., MDL No. 1725, Master Case No. 05 Md 1725, 2007 WL 518626 at *6 (E.D. Mich. Feb. 15, 2007); In re Royal Ahold N.V. Sec. & ERISA Litig., 220 F.R.D. 246, 250 (D. Md. 2004); In re WorldCom Inc. Sec. Litig., 234 F. Supp. 2d 301, 306 (S.D.N.Y. 2002).

[18] See, e.g., In re Metropolitan Sec. Litig., No. CV 04 25 FVS, 2005 WL 940898 at *3 (E.D. Wash. March 21, 2005); In re Williams Sec. Litig., No. 02 CV72H(M), 2003 WL 22013464 at *2 (N.D. Okla. May 22, 2003).

[19] In re WorldCom Inc. Sec. Litig., 234 F. Supp. 2d 301 (S.D.N.Y. 2002).

[20] Id., 234 F. Supp. 2d at 305 06.

[21] In re La Branche Sec. Litig., 333 F. Supp. 2d 178, 183 (S.D.N.Y. 2004); see also In re Royal Ahold NV Sec. & ERISA Litig., 220 F.R.D. 246, 251 52 (S.D.N.Y. 2004).