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Expert Analysis

Are the PSLRA Discovery Stay Exceptions Swallowing the Rule?

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The federal courts have continued to tighten the pleading requirements for federal securities fraud cases, with the result that an increasing number of cases are now dismissed each year for failure to meet those requirements, as set forth in the Private Securities Litigation Reform Act. Oddly, however, the companion discovery stay provision of the PSLRA has not been strictly enforced in a similar manner, despite the PSLRA's requirement that a plaintiff plead specific facts based on actual knowledge and not on knowledge acquired through discovery.

The PSLRA discovery stay provides that "all discovery and other proceedings 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." 15 U.S.C. §78u-4(b)(3)(B). In passing this provision, Congress sought to prevent plaintiffs from conducting fishing expeditions for evidence and to stem the extraordinary costs of discovery and settlements for claims that could not withstand dismissal. The legislative history leaves no doubt that the discovery stay provision was intended to be a complete stay absent some "exceptional circumstance" requiring limited discovery to preserve evidence or prevent undue prejudice.[1]

With little or no appellate guidance, and none in the U.S. Court of Appeals for the Second Circuit, the lower courts have taken different approaches in determining what constitutes "undue prejudice" for purposes of lifting the discovery stay during the pendency of a motion to dismiss. Although the majority of federal district courts appear to have required "unique" or "exceptional" circumstances to exist before permitting an exception to the discovery stay, as the PSLRA appears to require, a significant minority of courts seem to have strayed from the plain language of the provision to permit discovery without exceptional circumstances, such as where there is no great burden on defendants to provide discovery already gathered and produced to others and/or where Congress' purposes in enacting the discovery stay are not frustrated by permitting discovery.

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'In re BOA Securities'

In one recent Southern District case exemplifying this minority position, the court modified the PSLRA discovery stay to permit discovery, finding defendants had already produced or were going to produce the requested discovery in other non-PSLRA proceedings, there would be no undue burden on defendants to provide discovery, and Congress' purposes in enacting the PSLRA would not be frustrated. *In re Bank of Am. Corp. Sec., Derivative & Employment Ret. Income Sec. Act (ERISA) Litig.*, No. 09 MDL 2058 (DC), (SDNY Nov. 16, 2009) (*In re BOA Securities*) (Chin, J.).

> It would be helpful if the Second Circuit found a way to provide guidance to the district courts as to what circumstances rise to the level of 'undue prejudice.'

In *In re BOA Securities*, plaintiffs brought securities fraud claims against Bank of America in connection with its merger with Merrill Lynch alleging, among other things, failure to disclose Merrill's pre-closing losses and payment of large bonuses to corporate executives and employees. Various government agencies including the SEC, Congress, and the New York and North Carolina attorneys general opened investigations and a derivative lawsuit was filed in Delaware.

After agreeing upon a briefing schedule for defendants' motions to dismiss, plaintiffs sought to have the discovery stay lifted to obtain documents defendants "have produced or will produce" to various government agencies and transcripts of testimony in those investigations.[2] Plaintiffs claimed that without discovery their case "would lag substantially behind" discovery in the other actions. Indeed, plaintiffs argued this case was 'the type of case" where the PSLRA discovery stay "serves no rational purpose," and indeed that the discovery stay "was not intended to apply" to cases where the claims "are adequately alleged." Despite opposition pointing out that plaintiffs had failed entirely to demonstrate "undue prejudice," which requires exceptional circumstances,[3] the court granted plaintiffs' request. In doing so, the court concluded that plaintiffs would be "unduly prejudiced" if the discovery stay were not lifted because "[d]iscovery is moving apace in parallel litigation," plaintiffs would be "less able to make informed decisions about litigation strategy" and their pursuit of discovery will "fall substantially behind the SEC and other government actions."

As further support for its decision, the court noted that lifting the stay would not "frustrate Congress' purposes in enacting the provision" because plaintiffs were not seeking the discovery "to engage in a fishing expedition" and producing the documents would pose no additional burden on defendants who had already "collected, reviewed and organized the documents for production" in other proceedings "and the burden of making another copy for plaintiffs here will be slight." The court specifically rejected any requirement that plaintiffs demonstrate exceptional circumstances "to the extent it implies that something more than 'undue prejudice' is required." That statement, however, begs the question of what constitutes undue prejudice.

Courts Disagree on Standard

It would seem to circumvent the clear requirement of the PSLRA discovery stay provision and its limited exceptions to lift the discovery stay in reliance only upon a showing of minimal burden to the defendants or compliance with the general policies behind the PSLRA. *In re Spectrametics Corp. Sec. Litig.*, 2009 WL 3346611 (D. Colo., Oct. 14, 2009). Congress obviously knew its own purposes when it enacted the discovery stay, but it did not permit discovery in circumstances where discovery is "either less burdensome to the defendants than ordinary discovery or, perhaps, not burdensome at all." *Ross v. Abercrombie & Fitch Co.*, 2006 WL 2869588 at 2 (S.D. Ohio, Oct. 5, 2006).

Nor did Congress make the likelihood of success on the motion to dismiss a factor to be considered by the court, despite plaintiffs' frequent arguments on these motions that their claims are "meritorious," "not frivolous," or "are adequately alleged." And, despite the Court's rejection of exceptional circumstances as a requirement to lift the discovery stay in *In re BOA Securities*, the "exceptional circumstance" language appears in the PSLRA legislative history as required to permit "particularized discovery" during the pendency of a motion to dismiss.[4] Certainly a delay in gathering evidence or planning litigation strategy cannot constitute "undue prejudice," since that is the purpose of a stay. Indeed, most courts have found just that, observing that the delay in discovery is "an inherent part of every stay of discovery required by the PSLRA," *In re Initial Pub. Offering Litig.*, 236 F.Supp.2d 286, 287 (SDNY 2002), and that any discovery stay involves some degree of prejudice. *In re Sunrise Senior Living Inc. Derivative Litig.*, 584 F.Supp.2d 14, 18 (D.D.C. 2008).

Since "undue prejudice" requires something out of the ordinary, that something cannot be the existence of related government investigations or other actions: a large number of PSLRA securities actions are brought in instances where government investigations and other proceedings are also underway at the same time. Thus, the very existence of such proceedings cannot alone create the "undue prejudice" to which Congress referred. Id. at 18-19 (SEC investigations are "routine" and do not implicate the PSLRA's discovery stay exceptions).

In rejecting a request for relief from the discovery stay on grounds similar to those in *In re BOA Securities*, Judge Gerard Lynch set out succinctly why the existence of other proceedings cannot constitute "undue prejudice."

> 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' 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., 2006 U.S. Dist. LEXIS 55639, at 6-7. Many other federal courts around the country have similarly rejected parallel proceedings as a basis to find undue prejudice and thus to lift the stay.[5]

Nonetheless, some courts in the Southern District and elsewhere, cite two Southern District cases, as the court did here, as support to find undue prejudice where plaintiffs would be unable to make "informed decisions about their litigation strategy in a rapidly shifting landscape because they are the only major interested party without documents forming the core of their proceedings." *In re BOA Securities*, citing *In re WorldCom Inc. Sec. Litig.*, 234 F. Supp. 2d 301, 305 (SDNY 2002) and *In re LaBranche Sec. Litig.*, 333 F. Supp. 2d 178 (SDNY 2002). In each of those cases, however, the courts did at least articulate "undue prejudice" going beyond the prejudice inherent in the delay caused by a discovery stay or in the existence of parallel proceedings.

In *WorldCom*, the PSLRA discovery stay was lifted because the court found "unique circumstances" where the PSLRA plaintiffs, together with plaintiffs in a related ERISA litigation, were ordered to participate with the insolvent defendant in scheduled coordinated settlement discussions. Because the PSLRA plaintiffs were competing for a limited pool of assets with the ERISA plaintiffs, who were not subject to a discovery stay, the PSLRA discovery stay left the PSLRA plaintiffs "severely disadvantaged" in those discussions and resulted in the "very real risk" that the PSLRA plaintiffs would be left to pursue its action against a defendant with little or no assets. 234 F. Supp. 2d at 305.

Similarly, in *LaBranche*, the court found undue prejudice where defendants had already reached a very large settlement with regulatory authorities, again suggesting the discovery delay could harm plaintiffs' chance of recovery.[6] Despite the "unique circumstances" in *WorldCom* and the genuine finding of undue prejudice in *LaBranche*, both these cases have been cited and quoted with some frequency, without reference to their special circumstances, to permit discovery solely on the basis of unequal access to documents where other proceedings are pending.[7]

Even in the case where "undue prejudice" can be demonstrated and warrants a modification of the discovery stay, that modification must be limited to the "particularized" discovery necessary to prevent undue prejudice (or to preserve evidence). It is not always self-evident that a request for all documents (and testimony) provided to government agencies, even in related proceedings, is sufficiently "particularized" to constitute a proper request. Courts still should require plaintiffs to specify the types of documents sought and how those documents are relevant to their own claims.[8]

Conclusion

Although the Second Circuit has not had the opportunity to address the meaning of "undue prejudice," it has given a recent indication that it would not be prepared to lift the discovery stay absent "undue prejudice" created by exceptional circumstances. In *South Cherry Street LLC v. Hennessee Group LLC*, 573 F.3d 98 (2d Cir. 2009), the court upheld dismissal of a securities fraud claim finding plaintiffs had failed to plead facts giving rise to a strong inference of intent to defraud. In responding to plaintiffs' argument that it should not be required to plead more because the necessary facts were peculiarly within defendants' knowledge, the Second Circuit noted this argument "intimate[d] that it might hope to develop some such evidence in discovery." 573 F. 3d at 113-114. The Court rejected the argument, observing that "'before proceeding to discovery, a complaint must allege facts suggestive of illegal conduct,' *Twombly*, 550 U.S. at 564 n. 8, 127 S. Ct. 1955; and a plaintiff whose 'complaint is deficient under Rule 8…is not entitled to discovery,' *Iqbal*, 129 S.Ct. at 1954."[9]

Of course, the federal district courts have not lifted the PSLRA discovery stay to permit plaintiffs to develop evidence required to plead a non-dismissible complaint.[10] But, Congress did not intend its PSLRA discovery stay exceptions to be construed more liberally than the pleading rules applicable to all federal cases. The stay of discovery and the heightened pleading standards "are separate and distinct, yet complimentary mechanisms."[11] It would be helpful if the Second Circuit found a way to provide guidance to the district courts as to what circumstances rise to the level of "undue prejudice." In the meanwhile, the district courts should not permit discovery before ruling on motions to dismiss in PSLRA cases except in exceptional circumstances.

1. S. Rep. 104-98, at 14 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 693.
2. Letter from Co-Lead Counsel for Lead plaintiffs in *In re BOA Securities*, to Judge Denny Chin (Oct. 6, 2009) (filed on Nov. 30, 2009).
3. Letter from Peter C. Hein, Counsel for defendant in *In re BOA Securities*, to Judge Denny Chin (Oct. 8, 2009) (filed on Nov. 30, 2009).
4. S. Rep. 104-98, at 14 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 693.
5. See e.g., *In re Am. Funds Sec. Litig.*, 495 F. Supp. 2d 1103, 1106 (C.D. Cal. 2007); *Sisk v. Guidant Corp.*, 2007 WL 1035090 at 4 (S.D. Ind. March 30, 2007); *In re Odyssey Healthcare Inc.*, 2005 WL 1539229 at 2 (N.D. Tex. June 10, 2005).
6. Other cases have also cited related settlements as a basis to lift the discovery stay. See, e.g., *Waldman v. Wachovia*, 2009 WL 86763, at 2 (SDNY Jan. 12, 2009) ("unusual need for an early review of crucial records"). But see *In re Smith Barney Transfer Agent Litig.*, 2006 WL 1738078, at 2 (SDNY Jun. 26, 2006) (declining to find undue prejudice in an SEC settlement); *In re Lautronix Inc. Sec. Litig.*, 2003 WL 22462393 (C.D. Cal. Sept. 26, 2003) (declining discovery where corporate defendant had settled with other entities).
7. See e.g., *Seippel v. Sidley, Austin, Brown & Wood LLP*, 2005 WL 388561, at 2 (SDNY Feb. 17, 2005); *In re Firstenergy Corp. Sec. Litig.*, 229 F.R.D. 541, 545 (N.D. Ohio 2004); *Singer v. Nicor*, 2003 WL 22013905, at 2 (N.D. Ill. April 23, 2003).
8. See, e.g., *In re Am. 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). Other courts have found requests for documents already produced to be sufficiently particularized. *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 (SDNY 2002).
9. *Bell Atlantic v. Twombly*, 550 US. 554 (2007); *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009).
10. See e.g., *SG Cowen Sec. Corp. v. United States Dist. Court for the Northern Dist. of California*, 189 F. 3d 909 (9th Cir. 1999).
11. *Miller v. Champions Enters. Inc.*, 346 F.3d 660, 690 (6th Cir. 2003).

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