THE PSLRA "AUTOMATIC STAY" OF DISCOVERY

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In 1995, the Private Securities Litigation Reform Act ("PSLRA") added identical provisions to the Securities Act of 1933 ("Securities Act") and Securities Exchange Act of 1934 ("Exchange Act") staying discovery during the pendency of a motion to dismiss. An interesting situation arises when some parties move to dismiss and some parties answer the complaint. In that situation, the policy reasons for staying discovery do not apply, at least not as to all parties. This article will discuss the reasons for and against staying discovery in these circumstances and the approaches taken by courts in dealing with the issue.

The Statutory Stay.

Both the Securities Act and Exchange Act now state: "In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss. . . ."[1] This provision was added to the federal securities laws in 1995 to save defendants the cost and burden of discovery in a case that might be dismissed. The rationale behind this rule was that Congress found approximately 80% of the costs of litigating securities class actions was associated with discovery and such costs should be incurred by a litigant only after the court has ruled on the sufficiency of the complaint.[2] Prior to 1995, a defendant in a federal securities case would have to participate in discovery during the pendency of a motion to dismiss, incurring unnecessary costs if the case was dismissed. Congress was also concerned that without the stay, a meritless complaint could be filed and the discovery process used to find a basis for the lawsuit.[3]

Lifting The Statutory Stay.

Even when all defendants move to dismiss, courts have discretion to lift the discovery stay. In a case involving multiple defendants, when some defendants move to dismiss and some

defendants answer the complaint, courts are placed in a bind. As to those defendants who have answered the complaint, discovery is inevitable. Staying discovery with regard to those defendants does nothing but delay the action, running afoul of FED. R. CIV. P. 1, which aims at securing the just, speedy, and inexpensive determination of every action. However, as to those defendants who have moved to dismiss, while document discovery may be unavoidable even as a third party if the claims against them are dismissed, depositions could be an expensive and unnecessary proposition.

Then-District Judge Sotomayor ruled along these lines in *Adair v. Kaye Kotts Associates, Inc.* In *Kaye Kotts*, the plaintiff sued an issuer, the signatories to the registration statement, and the issuer's auditor for claims arising from an initial public offering. The company and the individual defendants answered, and the auditor moved to dismiss. The plaintiff wanted to take discovery and the auditor objected. Judge Sotomayor issued a memo endorsement, allowing document discovery to proceed and requiring the parties to report back to the court before depositions were to begin. The memo endorsement stated "[t]here are multiple defendants in this action and only one has moved to dismiss. I agree that discovery against that defendant, Feldman Radin, should be stayed. Discovery . . . particularly with respect to documents, should proceed among the other defendants. At the point depositions are to commence, the parties should advise the court in order for the court to determine if the Feldman stay should continue."[4] Thus plaintiff received documents from the non-moving parties which would have to have been produced eventually, regardless of the outcome of the motion to dismiss.

A district court in Massachusetts allowed discovery to proceed against defendants who moved to dismiss and had their motion denied, when motions to dismiss by other defendants were still pending. In *In re Lernout & Hauspie Sec. Litig.*,[5] the court found that allowing discovery

against those defendants was consistent with the intent of the stay provision, since such discovery would not be a fishing expedition or an attempt to coerce an innocent party into discovery. The court also reasoned that once the motion to dismiss was denied and the mandates of the PSLRA were satisfied, "the general presumption for liberal discovery provides the backstop." The court allowed document requests and interrogatories upon the parties who lost the motion to dismiss and document subpoenas on non-parties, limited to the claims sustained against the moving parties. No depositions were to be taken without leave of court.

Refusing To Lift The Statutory Stay.

The same issue arose in *In re Aid Auto Stores, Inc. Sec. Litig.*,[6] a case brought under section 10(b) of the Exchange Act against a company, two individual defendants, and the company's auditor. Only the auditor moved to dismiss. The plaintiffs moved to lift the statutory stay against the auditor, arguing 1) that the auditor would eventually produce the documents either as a defendant or a third party, 2) that the bulk of the documents had already been produced in another litigation arising out of the same facts and there would be no burden on the auditor to simply make another copy of this prior production, and 3) there would be undue prejudice if the plaintiff in the other litigation were to advance its case to trial first and take the company's limited assets.[7] The court held oral argument and issued a one-line order denying the motion to lift the stay "for the reasons stated on the record at the end of oral argument."[8] The court stated at the close of the oral argument on this issue that the plaintiffs were under a heavy burden to lift the stay, and "[w]hile I ordinarily would not be inclined to stay discovery under these circumstances, I'm obliged to enforce the provisions of the PSLRA."[9] The non-moving defendants did not argue the statutory stay applied to them and discovery proceeded against them.

In *In re CFS-Related Sec. Fraud Litig.*,[10] some defendants answered the complaint and the other defendants moved to dismiss. In this case, the issue was whether document discovery should be allowed by the non-moving defendants. The answering defendants had also moved to dismiss cross-claims by other defendants. Plaintiffs moved to compel one of the answering defendants to produce documents. The court held "[a]s long as any defendant has filed a motion to dismiss claims arising under Chapter 2B of the 1934 Securities Act, the PSLRA stays 'all discovery,' even discovery against answering non-moving defendants." The court's rationale was that if the stay were not granted, "the PSLRA's stay would be of little benefit to those defendants who do move to dismiss." The court reasoned that a moving defendant will, at a minimum, want to "monitor" discovery to protect its own interests. In addition, the court said it would be inefficient to have the non-moving defendants respond to document requests twice, which it would have to do if the moving defendant lost its motion and then served document requests on its co-defendants.

Discussion

The stay during a motion to dismiss is an exception to the general rule that discovery should commence immediately and therefore should be narrowly construed. With respect to the interests of the moving party, the *CFS* court failed to appreciate the distinction between document productions and depositions as did the *Kaye Kotts* and *Lernout & Hauspie* courts. It takes no resources and a defendant has no interests at issue when another party is simply producing documents or responding to interrogatories. These are only considerations at depositions, when the moving defendant would have to prepare, review the relevant documents, and examine the witness as to any issues relating to cross-claims, indemnification, or contribution, in case it lost its motion. The *CFS* court gave the broadest possible construction to the exception of the PSLRA stay by

refusing to allow discovery even of the non-moving parties at the expense of the remedial purposes of the securities laws and the swift resolution of the case. In contrast, the *Kaye Kotts* and *Lernout & Hauspie* courts gave the narrowest construction to the PSLRA stay, while protecting the rights of the moving party and imposing no unnecessary costs upon it.

Other courts have recently given narrow construction to the stay, using some of the reasons rejected by the *Aid Auto* court The third argument advanced by the plaintiffs in *Aid Auto*, that there would be undue prejudice because plaintiffs in other litigation would have an advantage, carried the day in *In re Worldcom, Inc. Sec. Litig.* In *Worldcom*, there was no decision on a motion to dismiss or an answer yet, but Judge Cote held that under the "unique circumstances" of the case, where the complaint was "clearly not" a fishing expedition or an attempt to coerce a settlement, production of documents already produced in other litigations was permitted. "Without access to documents already made available [to litigants in other cases or bankruptcy creditors'] NYSCRF would be prejudiced by its inability to make informed decisions about its litigation strategy in a rapidly shifting landscape."[11] The second argument advanced in *Aid Auto*, that the documents had already been produced in another case, carried the day in the *Enron* litigation. The plaintiffs moved to lift the automatic stay to obtain documents produced by Enron in response to legislative or executive branch investigations. The district court held that while the PSLRA discovery stay was to protect defendants from unnecessary discovery costs, "[i]n a sense discovery has already been make, and it is merely a question of keeping it from a party because of the restrictions of statute designed to prevent discovery abuse," and ordered production of the documents.[12]

When a defendant answers a complaint or loses a motion to dismiss, the general purpose of the PSLRA is satisfied in that a defendant or a court has decided the claims are at least

facially meritorious and should proceed towards trial. The balancing between the general purposes of the federal securities laws, which is essential to public confidence in the securities markets, and the narrow purpose of the stay provisions of the PSLRA is best accomplished by allowing discovery against non-moving defendants. This allows for faster resolution of the cases, bringing closure for the defendants, the investors who lost their money, and the investing public as a whole which needs confidence that transgressions of the securities laws are dealt with quickly and justly. The federal securities laws were passed in the 1930s to help restore investor confidence in the public securities markets after the crash of 1929. If the securities laws are viewed by the public as a source of interminable delays to recovery, especially with regard to defendants who have admitted the sufficiency of the allegations against them, investor confidence in the securities markets will be undermined. With the need for strong securities laws and effective remedies now more evident than ever, after the debacles of Enron, Worldcom, et al., the wisdom of the PSLRA is in doubt and some in Congress are calling for its wholesale repeal.[13] The PSLRA should be afforded the narrowest construction possible, and the civil litigation contemplated by the federal securities laws should be allowed to proceed so that these cases have the quickest possible resolution.

CONCLUSION

Many courts have lifted the PSLRA's discovery stay, for a variety of reasons. The situation where one party answers the complaint, making discovery inevitable, moots most of the concerns which motivated Congress to include the discovery stay in the PSLRA. In these circumstances, it is appropriate to lift the stay with regard to document discovery. This helps insure the speedy disposition of the case and imposes no unnecessary burden on the moving defendants. By limiting the discovery to documents, the moving defendant is protected from the potentially

unnecessary cost of depositions. Finally, there is no danger of a plaintiff "discovering" his way into a sustainable complaint, as the answering defendant has admitted by answering that there is no basis to challenge the legal sufficiency of the complaint.

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

2. *See* S. Rep. 104-98, 683, 688, 693 (1995), *reprinted in* 1995 U.S.C.C.A.N. 699.

3. *See* 141 Cong. Rec. at 413699.

4. *Adair v. Kaye Kotts Assocs., Inc.*, 97 Civ. 3375 (S.D.N.Y. Sept. 24, 1997) (mem.).

5. 2002 WL 1733927 (D. Mass. July 26, 2002).

6. CV-98-7395 (DRH) (E.D.N.Y.).

7. The parties agreed document discovery would proceed with the non-moving parties.

8. *In re Aid Auto Stores Inc., Sec. Litig.*, CV-98-7395 (DRH), order at 1 (E.D.N.Y. Oct. 2, 2000) (Boyle, M.J.).

9. Transcript of Oral Argument, at 15, *In re Aid Auto* (E.D.N.Y. Oct. 2, 2000).

10. 179 F. Supp. 2d 1260 (N.D. Okla. 2001).

11. 2002 WL 31628566, at *4 (S.D.N.Y. Nov. 21, 2002).

12. *In re Enron Corp. Sec. Deriv. & "ERISA" Litig.*, MDL-1446 (S.D. Tex. Aug. 16, 2002).

13. Rep. Bart Stupak of Michigan sponsored a repeal bill in February 2002.