10/21/2005 N.Y.L.J. 4, (col. 4)

New York Law Journal
Volume 234

Friday, October 21, 2005

OUTSIDE COUNSEL

Staying Derivative Actions Pursuant to PSLRA and SLUSA

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Derivative actions alleging violations of state corporate law by a company's directors are often filed concurrently with private securities class action lawsuits filed in federal court.

This article discusses the applicability of stays of discovery authorized by the Private Securities Litigation Reform Act (PSLRA) and the Securities Litigation Uniform Standards Act (SLUSA) to derivative actions.

In 1995, Congress enacted the PSLRA, which, among other things, mandated a stay of discovery in federal securities actions during the pendency of a motion to dismiss. In 1998, Congress enacted SLUSA, which authorized a federal court hearing a federal securities action to stay discovery proceedings in a state court ‘upon a proper showing.‘ Several federal and state cases have recently examined this issue.

Pursuant to the PSLRA, discovery in federal securities actions is automatically stayed during the pendency of a motion to dismiss.[FN1] SLUSA provides that ‘a [federal district] court may stay discovery proceedings in any private action in a State court as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this subsection.‘[FN2] SLUSA, however, does not apply to ‘an exclusively derivative action.‘[FN3]

Plaintiffs in a derivative action may obtain discovery as a natural consequence of filing a case. In certain states, most notably Delaware, discovery in derivative actions is stayed during the pendency of a motion to dismiss, similar to the stay provided by the PSLRA.[FN4] Many of those states, including Delaware, nevertheless allow and even encourage plaintiffs to make a ‘books and records‘ demand on a company's board of directors before filing a lawsuit, for a ‘proper purpose.‘[FN5] Defendants will often seek to quash a books and records demand on the grounds that providing such discovery would negate the effects of the PSLRA's discovery stay.

Treatment in Courts

1. Cases Denying Discovery Stays in Derivative Actions. In Magid v. Acceptance Insurance Companies Inc.,[FN6] the defendants sought to dismiss a books and records demand complaint (filed in Chancery Court after the corporation refused to comply with a books and records demand), claiming that the plaintiff's stated purpose for the demand was a subterfuge to circumvent the PSLRA discovery stay automatically already in place. Because the plaintiffs' attorneys involved in the federal securities case were not counsel to the plaintiff in the books and records demand case, and those attorneys were willing to stipulate to a protective order, the court found that ‘the plaintiff's true pur-

pose is, as his demand indicates, to investigate possible mismanagement. The Court therefore rejects the defendant's assertion that the plaintiff has been used as a shill‘ by both derivative and federal securities counsel to pursue discovery in the federal case.

'In re Tyco Int'l'

The same conclusion was reached in In re Tyco Int'l, Ltd. Multidistrict Litigation,[FN7] where the defendants sought to stay discovery under the Employee Retirement Income Security Act (ERISA) and derivative actions. The federal district court noted that the ERISA and derivative actions were filed by different plaintiffs, with different counsel, than the federal securities action. The court also found that there was no evidence of collusion to thwart the PSLRA's discovery stay. The defendants also argued that if the ERISA and derivative plaintiffs uncovered new evidence of wrongdoing, they would amend their complaints and thus provide the plaintiffs in the federal securities action information that could be used to draft an amended federal securities complaint. The court found such an argument unavailing, stating that denial of the stay would not encourage the filing of frivolous securities actions. The court noted that ‘[i]n any event, any interest that the defendants have in delaying discovery does not override the legitimate interest that the plaintiffs in the ERISA and Derivative actions have in obtaining an expeditious resolution of their claims.‘

The court then went a step further and actually granted the federal securities plaintiffs' request for access to documents produced in the ERISA and derivative actions holding that:

(1) the Securities Action plaintiffs would be at a serious disadvantage if they are denied access to documents that are produced to other plaintiffs and government investigators; (2) the defendants will not incur any additional costs if the Securities Action plaintiffs are given access to the documents; (3) keeping all parties on an equal footing with respect to discovery serves important case management interests in this complex litigation; and (4) none of the claims at issue are frivolous.

In In re First Energy Shareholder Derivative Litigation,[FN8] the Delaware Chancery Court allowed discovery, and also allowed the derivative plaintiffs to share discovery with the plaintiffs in the securities action. Similarly, in Cohen v. El Paso Corp.,[FN9] the Delaware Chancery Court found that the plaintiff's books and records demand had a proper purpose, the investigation of ‘possible waste and mismanagement,‘ where the books and records demand] suit was filed ‘after El Paso publicly announced a $1 billion write-down as a result of improper accounting for proved reserves. Additionally, the SEC launched a formal investigation into El Paso's accounting practices. Both of these incidents provide a credible purpose in investigating waste and mismanagement.‘

The court then held that the plaintiff did not act in bad faith as the federal securities action class had not been certified, there were no ties between the plaintiff in the derivative action and the plaintiffs in the securities action, and the plaintiff was willing to enter into a confidentiality agreement. The opinion had little practical effect, as the federal district court presiding over the related securities case issued a one-line order staying the Cohen action.[FN10]

'Gilead Sciences Securities'

In Gilead Sciences Securities Litigation,[FN11] the federal district court denied the defendants' motion for a discovery stay in state derivative litigation, finding that a protective order would sufficiently prevent the sharing of discovery. The court also found that the likelihood of overlapping federal and derivative claims did not warrant a stay. ‘[T]he focus should be on whether discovery in the state action will adversely affect a court's ability to decide a federal securities action, not whether the state claims mirror the federal claims.‘ The court also found that the discovery requests would be not unduly burdensome where ‘the burden on Defendants to comply with the discovery requests of State Plaintiffs, who must amend their state complaint, is not so unreasonable as to warrant this Court granting a stay of discovery.‘

In City of Austin Police Retirement System v. ITT Educational Services, Inc.,[FN12] the federal district court found that a discovery stay is not warranted in derivative actions or demand requests, as long as the derivative action or demand request is not intended merely to evade the automatic discovery stay in a related federal action. ‘Congress took care to preserve the authority of state law and state courts over core areas of corporation law, including shareholder derivative actions and the relationship between shareholders and corporate directors and officers.‘ The court then turned to the intent of plaintiff and his counsel in making a books and records demand, and noted that ‘an intent to evade the PSLRA stay of discovery would weigh heavily in favor of a stay under SLUSA, at least where the state court proceeding is not a securities fraud claim.‘ The court found, however, that there was no convincing evidence of such intent.

Cases Allowing Stays

2. Cases Allowing Derivative Action Discovery Stays. The first federal district court to grant a stay of discovery in a derivative case under SLUSA, with analysis, is In re DPL, Inc. Securities Litigation,[FN13] where:

During oral argument...an attorney representing some of the Plaintiffs in these consolidated [federal securities law] cases as well as the Plaintiffs in [the derivative action], indicated that he anticipated sharing discovery obtained in that state court proceeding with the other counsel representing Plaintiffs in these consolidated [federal] actions.

The plaintiffs had argued that discovery stays are inapplicable to derivative actions because derivative actions are excluded from the definition of ‘covered class action.‘ The court, instead, focused on that part of the statute that ‘expressly provides that a District Court can stay discovery in 'any private action’ pending in a state court, rather than merely in a 'covered class action,'‘ holding that:

Simply stated, if this Court does not stay discovery in [the derivative action], its jurisdiction to rule on a motion to dismiss the federal securities claims, before any discovery has been conducted, will have been circumvented by discovery in the state court actions and, therefore, compromised.

On March 1, 2005, in In re Cardinal Health, Inc. Securities Litigation,[FN14] a federal district court stayed discovery in a derivative action, holding that the ‘state court derivative claim [was] predicated almost entirely on the gravamen of the complaints pending in this Court: securities fraud.‘ The court justified the discovery stay to prevent three things: 1) the circumvention, inadvertent or otherwise, of the PSLRA's discovery stay;[FN15] 2) the possibility of inconsistent rulings; and 3) an excessive burden of discovery on both the defendants and judicial resources. This, despite the derivative plaintiff having filed her complaint more than a year before the filing of the federal securities complaint, the absence of overlapping attorney representations, and the existence of a confidentiality agreement.

Conclusion

The explicit language in SLUSA states that the automatic stay of discovery mandated by the PSLRA does not apply to an exclusively derivative action. In those six cases where the court refused to impose a discovery stay, a recurring theme is this issue of whether the derivative action is genuine in and of itself, or whether it is just a subterfuge to circumvent the discovery stay in the federal case.

In those cases that stayed discovery, the theme was the negative impact of the derivative discovery on the federal securities case. The DPL court stayed discovery based on derivative counsel's admission that they would share the fruits of the derivative discovery with the federal securities counsel. The Cardinal Health court, however, took a hard line by holding that the gravamen of the derivative action was securities fraud which added the possibility, inadvertent or otherwise, of the circumvention of the federal securities action's discovery stay, the possibility of inconsistent rulings, and an excessive burden of discovery on both the defendants and on judicial resources.

Thus, of the eight cases analyzed, seven denied a stay of discovery in the derivative action, frequently with the proviso that the discovery would not be shared with the federal securities action. One stayed discovery based upon the derivative action counsel's stated intent to share the fruits of that discovery with the federal securities action. Only one stayed discovery despite the absence of evidence of collusion and where the derivative complaint was filed a year before the federal securities complaint.

FN1. Securities Act of 1933, 15 USC §77z-1(b)(1); Securities Exchange Act of 1934, 15 USC §78u-4(b)(3)(B).

FN2. 15 USC §77z-1(b)(4); 15 USC §78u-4(b)(3)(D).

FN3. 15 USC §77p(f)(2)(b); 15 USC §78bb(f)(5)(c).

FN4. Del. Court of Chancery Rule 23.1.

FN5. 8 Del. Code §220(b)(2)b2.

FN6. No. Civ. A. 17989-NC, 2001 WL 1497177, *9 (Del. Ch. Nov. 15, 2001).

FN7. No. 02-1335-B, 2003 WL 23830479, *4 (D.N.H. Jan. 29, 2003).

FN8. 219 FRD 584, 586-87 (N.D. Ohio 2004).

FN9. No. Civ. 551-N, 2004 WL 2340046, *2 (Del. Ch. Oct. 18, 2004).

FN10. Wyatt v. El Paso Corp., No. H-02-2717 (S.D. Tex.).

FN11. 3:03-cv-4999 (MJJ), *3 (N.D. Cal. Nov.18, 2004)

FN12. 1:04CV0380-DFH-TAB, 2005 WL 280345, *12 (S.D. Ind. Feb. 2, 2005).

FN13. 247 FSupp2d 946, 950 (S.D. Ohio 2003).

FN14. 365 FSupp2d 866 (S.D. Ohio 2005).

FN15. The court found that ‘the provision, as applied to state court derivative actions, does not require a showing that the state court plaintiff intended to circumvent the PSLRA.‘
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