

## California State Court Applies Discovery Stay in Securities Act Claim

*A recent decision, if widely adopted, could spare companies from unnecessary discovery costs in claims that may not survive a threshold pleadings challenge.*

### Key Points:

- State courts across the country have reached conflicting conclusions on whether the Private Securities Litigation Reform Act's (PSLRA) automatic stay of discovery pending a ruling on a complaint's legal sufficiency applies to cases filed in state court.
- Breaking from the majority approach among California courts, a San Mateo County Superior Court conducted a thorough statutory interpretation analysis and concluded that the PSLRA requires a stay of discovery in state court.
- If state courts were to reach consensus on this conclusion — or if the US Supreme Court were to adopt it — securities plaintiffs would possess less leverage to coerce settlements by filing in state court and forcing companies to engage in early discovery.

On July 25, 2022, a California state court held that the PSLRA imposes an automatic stay of discovery during the pendency of a motion to dismiss or its equivalent in state-court actions arising under the Securities Act of 1933.<sup>1</sup> Recognizing that this question has divided state courts across the country, the court urged the US Supreme Court to provide the “last word” on this important and recurring issue “as soon as possible.”<sup>2</sup>

### Background

The Securities Act of 1933 imposes disclosure obligations on issuers seeking to sell securities to the public. In general, Section 5 of the Securities Act requires issuers to register securities offerings with the Securities and Exchange Commission.<sup>3</sup> Section 12(a)(1) imposes liability on any person who sells unregistered securities,<sup>4</sup> and “control persons” of a seller of unregistered securities may be held liable pursuant to Section 15.<sup>5</sup> Private plaintiffs may bring certain Securities Act claims — including claims under Sections 12(a)(1) and 15 — in either federal or state court.<sup>6</sup>

### PSLRA Discovery Stay

In 1995, seeking to combat abuses of the Securities Act and the Exchange Act of 1934, Congress enacted the PSLRA.<sup>7</sup> The PSLRA's reforms included mandatory sanctions for frivolous litigation, a

heightened pleading standard for certain claims, a “safe harbor” for forward-looking statements, and, as relevant here, a prohibition on discovery until after a complaint has survived a motion to dismiss.<sup>8</sup> Specifically, the PSLRA stay provision provides that “[i]n any private action arising under this subchapter” — meaning the Securities Act — “all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss.”<sup>9</sup>

### **The Divide Among State Courts**

The PSLRA stay undisputedly applies to Securities Act claims brought in federal court. But state courts have sharply divided on whether to apply the PSLRA stay. Indeed, even courts within the same jurisdiction have reached different outcomes on the issue, meaning that the stay’s application may turn on which judge the parties draw in a given case. This division persists because a state court’s decision on whether to stay discovery is effectively unreviewable after a final judgment, and state appellate courts have thus far declined to address the issue in an interlocutory posture.

The resulting discontinuity between federal and state discovery regimes has significant consequences. The potential to obtain early discovery creates an incentive for plaintiffs to bring Securities Act claims in state court in hopes of coercing defendants into settling unmeritorious claims rather than bearing steep pre-answer discovery costs.<sup>10</sup>

### **The Supreme Court Takes Notice**

The US Supreme Court was poised to resolve this split among state courts in *Pivotal Software, Inc. v. Superior Court of California*.<sup>11</sup> There, a California Superior Court refused to apply the discovery stay, and the California Court of Appeal and California Supreme Court summarily denied defendants’ petitions for review. The US Supreme Court took the extraordinary step of granting certiorari to review the Superior Court’s decision declining to stay discovery, but a settlement prior to the completion of merits briefing left the issue open.

### ***Ocampo v. Williams***

In recent years, cryptocurrency issuers and trading platforms have faced an increasing number of private suits and class-action claims.<sup>12</sup> *Ocampo v. Williams* is part of this growing trend. In a suit filed in San Mateo County Superior Court, Plaintiff Daniel Ocampo alleged that Dfinity USA Research LLC and Dfinity Stiftung, along with Andreessen Horowitz (a16z) and Polychain Capital LP, promoted and sold Internet Computer Project (ICP) tokens as unregistered securities in violation of Sections 5, 12(a)(1), and 15 of the Securities Act. In a parallel federal action, another plaintiff brought the same Securities Act claims against the two Dfinity defendants in the Northern District of California.

In the federal action, discovery was stayed pending a ruling on a motion to dismiss pursuant to the PSLRA. But in California, as in other states, the PSLRA stay’s applicability in state court remains unsettled. Though some California courts have applied the PSLRA stay, most have refused to do so.<sup>13</sup> In *Ocampo v. Williams*, when each state-court defendant filed a demurrer challenging the sufficiency of the complaint’s allegations, the Superior Court stayed discovery temporarily pursuant to its inherent authority and ordered briefing on the PSLRA stay’s applicability in state court.

On behalf of a16z, and joined by a16z’s co-defendants, Latham & Watkins filed a motion to stay discovery. That briefing advanced a straightforward textual argument for applying the stay in state court: because Subsection 77z-1(b) requires a stay of discovery in “any private action arising under” the Securities Act, the stay applies in both federal and state proceedings.<sup>14</sup> The briefing explained that statutory context and the PSLRA’s purpose further supported this plain-text reading.

Without ruling on the stay motion, the court sustained each defendant's demurrer with leave to amend, holding that plaintiff failed to allege that any defendant qualified as a statutory seller of securities or engaged in a domestic transaction.<sup>15</sup> Though plaintiff filed an amended complaint against all defendants, plaintiff agreed with a16z and Polychain that the court's grounds for dismissing the original complaint applied with equal force to the amended complaint, foreclosing any claim against them. Accordingly, pursuant to the parties' stipulation, the court dismissed a16z and Polychain from the case. But because plaintiff persisted with the amended complaint against the Dfinity defendants, Latham's discovery stay motion remained ripe for consideration. Counsel for Dfinity from Cravath, Swaine & Moore and Quinn Emanuel Urquhart & Sullivan presented oral argument and submitted supplemental briefing related to the stay motion.

The court held that the PSLRA stay applies in state-court actions. In doing so, the court adopted defendants' arguments regarding the PSLRA stay's text, context, and purpose.

First, the court recognized that giving the phrase "any private action arising under this subchapter" its "ordinary meaning" favored applying the stay in "state court actions arising under the '33 Act" during the pendency of a "motion to dismiss."<sup>16</sup> In other words, because "any" means "any," the statute's instruction that the stay applies in "any private action arising under" the Securities Act encompasses state-court actions.

Second, statutory context confirmed that a stay of discovery applies in state court and federal court alike. Just as with the PSLRA stay provision, Section 77z-2's safe-harbor provision shielding certain forward-looking statements from liability applies in "any private action arising under" the Securities Act. As the Supreme Court has made clear, the safe harbor operates in state and federal actions.<sup>17</sup> The Superior Court thus reasoned that the identically worded stay provision must also apply in state-court actions.<sup>18</sup> And, according to the court, that conclusion becomes inescapable when one considers that the safe-harbor provision itself includes a discovery-stay provision for certain motions for summary judgment.<sup>19</sup> Because the safe harbor provision, including its discovery stay, applies in state court, the court concluded that the similarly structured PSLRA stay applies in state court.

This is so, the court reasoned, even though not every state uses the term "motion to dismiss" to refer to a pleadings challenge. The court explained that the PSLRA stay's reference to a "motion to dismiss" and the safe-harbor stay's reference to a "motion for summary judgment" are umbrella terms for procedural devices used to challenge the legal sufficiency of allegations or undisputed facts, respectively.<sup>20</sup> Indeed, the court recognized that Federal Rule of Civil Procedure 12(b)(6) "does not even refer to a pleadings challenge as a 'motion to dismiss,'" dispelling the notion that the PSLRA stay operates only in federal-court litigation.<sup>21</sup> Had Congress wished to limit these discovery stays to federal actions, Congress would have said so, as it did when it limited the provisions of Subsection 77z-1(a) to actions brought "pursuant to the Federal Rules of Civil Procedure."<sup>22</sup> In the court's view, the language confining Subsection 77z-1(a) to federal actions creates a clear contrast with Subsection 77z-1(b)'s provisions, which lack any such limitation.<sup>23</sup>

Third, the court explained that applying the stay in state court aligns with the PSLRA's purpose. Because Congress sought to deter abusive practices in securities litigation, including "vexatious discovery requests," there is no reason why Congress would have wanted plaintiffs to file Securities Act cases in state court, where discovery may be easier to obtain.<sup>24</sup> Indeed, the court recognized that a contrary result would create an "absurd incentive" for securities plaintiffs.<sup>25</sup>

The court also dispatched several common counterarguments raised by state-court securities plaintiffs. Plaintiff argued that the Supreme Court's decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund* drew a distinction between "substantive" provisions that apply in both federal and state actions and "procedural" provisions such as the PSLRA stay that apply only in federal court.<sup>26</sup> Rejecting this argument, the court explained that *Cyan's* ruling "relied upon its analysis of specific language in the relevant statutes and not on any distinction between substantive and procedural reforms made by the PSLRA."<sup>27</sup>

Nor did the separate stay provision created by the Securities Litigation Uniform Standards Act (SLUSA)<sup>28</sup> require a different result. That provision allows a court presiding over a Securities Act case in which the PSLRA stay is in effect to stay discovery in any other private action, including a case raising only state-law claims, "as necessary in aid of [the court's] jurisdiction, or to protect or effectuate its judgments."<sup>29</sup> Because the SLUSA stay serves a separate function from the PSLRA stay by reaching cases the PSLRA stay does not, the court reasoned that applying the PSLRA stay to federal and state-court actions does not render the SLUSA stay superfluous.<sup>30</sup>

Finally, the court rejected plaintiff's argument that the Tenth Amendment precluded application of the PSLRA discovery stay in state court. Relying on decades of Supreme Court precedent, the court explained that Congress may impose procedural rules for federal causes of action litigated in state courts.<sup>31</sup>

## Potential Impact

The decision in *Ocampo* is a significant win for state-court defendants facing Securities Act claims. *Ocampo* offers a model for how state courts should analyze the PSLRA stay provision's text, context, and purpose. As the *Ocampo* court recognized, careful consideration of those factors requires the conclusion that the PSLRA stay applies equally in federal and state-court Securities Act cases. Simply put, "any" means "any," including in state court. This conclusion, if widely adopted, would ensure that companies are not forced to incur unnecessary discovery costs when a plaintiff's claim is incapable of surviving a threshold pleadings challenge. *Ocampo's* thorough analysis may help turn the tide of California decisions toward applying the PSLRA stay and persuade other state courts to reach the same result.

As the court in *Ocampo* recognized, this issue may soon return to the US Supreme Court, allowing it to provide "the last word" on the PSLRA stay's applicability in state court.<sup>32</sup> But unless and until the Supreme Court provides a definitive answer, companies facing Securities Act claims in state court should strongly consider citing and relying on *Ocampo* when arguing that the PSLRA requires a stay of discovery in state court.

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The views expressed in this Client Alert are Latham's and not those of any party that Latham represents in the case. If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

**Susan E. Engel**

susan.engel@lw.com  
+1.202.637.3309  
Washington, D.C.

**Matthew Rawlinson**

matt.rawlinson@lw.com  
+1.650.463.3076  
Silicon Valley

**Samir Deger-Sen**

samir.deger-sen@lw.com  
+1.202.906.4619  
New York

**Peter Trombly\***

peter.trombly@lw.com  
+1.332.240.1453  
New York

**Morgan E. Whitworth**

morgan.whitworth@lw.com  
+1.415.395.8011  
San Francisco

\*Admitted to practice in Virginia only.

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**Endnotes**

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- <sup>1</sup> Order Granting Stay Motion, *Ocampo v. Williams*, 21-CIV-03843, slip op. at 9 (San Mateo Cal. Super. Ct. July 25, 2022) (*Ocampo*).
  - <sup>2</sup> *Id.*
  - <sup>3</sup> 15 U.S.C. § 77e
  - <sup>4</sup> *Id.* § 77(a)(1).
  - <sup>5</sup> *Id.* § 77o.
  - <sup>6</sup> See *Cyan, Inc. v. Beaver Cnty. Emps. Ret. Fund*, 138 S. Ct. 1061, 1066 (2018).
  - <sup>7</sup> *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006).
  - <sup>8</sup> *Id.* (citing 15 U.S.C. § 78u-4); see also 15 U.S.C. §§ 77z-1, 77z-2.
  - <sup>9</sup> 15 U.S.C. § 77z-1(b)(1).
  - <sup>10</sup> See Michael Klausner et al., *State Section 11 Litigation in the Post-Cyan Environment (Despite Sciabacucchi)*, 75 *The Business Lawyer* 1769, 1781-82 (2020).
  - <sup>11</sup> 141 S. Ct. 2884 (2021) (Mem.).
  - <sup>12</sup> See generally Sam Skolnik, *Crypto Lawsuit Deluge Has Big Firms Scrambling to Keep Up*, *Bloomberg Law* (May 17, 2022, 5:30 AM), <http://news.bloomberglaw.com/business-and-practice/crypto-lawsuit-explosion-has-big-law-scrambling-to-keep-up>.
  - <sup>13</sup> Compare, e.g., Notice of Ruling at 2, *Shores v. Cinergi Pictures Ent., Inc.*, No. BC149861 (L.A. Cal. Super. Ct. Sept. 11, 1996) (applying PSLRA stay in state court); Order Re Motion to Dismiss Or Stay at 2, *In re Pronai Therapeutics, Inc. S'holder Litig.*, No. 16CIV02473 (San Mateo Cal. Super. Ct. Mar. 14, 2018) (same), with, e.g., *Switzer v. Hambrecht & Co., L.L.C.*, Nos. CGC-18-564904, CGC-18-565324, 2018 WL 4704776, at \*1 (San Fran. Super. Ct. Sept. 19, 2018) (refusing to stay discovery); Order

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re: Case Management at 1, *Plymouth Cnty. Contributory v. Adams Pharms., Inc.*, No. RG19018715 (Alameda Cal. Super. Ct. July 26, 2019) (same).

<sup>14</sup> 15 U.S.C. § 77z-1(b)(1).

<sup>15</sup> Order Sustaining Demurrers With Leave To Amend, *Ocampo v. Williams*, 21-CIV-03843, slip op. at 4-6 (San Mateo Cal. Super. Ct. Apr. 8, 2022).

<sup>16</sup> *Ocampo* at 3.

<sup>17</sup> See *Cyan*, 138 S. Ct. at 1066 (citing 15 U.S.C. § 77z-2(c)(1)).

<sup>18</sup> *Ocampo* at 3-4.

<sup>19</sup> The safe-harbor stay provision provides that “[i]n any private action arising under this subchapter, the court shall stay discovery . . . during the pendency of any motion by a defendant for summary judgment that is based on” the safe harbor’s applicability. 15 U.S.C. § 77z-2(f).

<sup>20</sup> See *Ocampo* at 4.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 4-5 (quoting 15 U.S.C. § 77z-1(a)).

<sup>23</sup> *Id.* at 5.

<sup>24</sup> *Id.* at 6 (quoting *Tellabs, Inc. v. Makor Issues & Rts., Ltd.*, 551 U.S. 308, 320 (2007)).

<sup>25</sup> *Id.* (quoting *In re Everquote, Inc. Sec. Litig.*, 106 N.Y.S.3d 828, 837 (N.Y. Sup. Ct. Aug. 7, 2019)).

<sup>26</sup> See 138 S. Ct. at 1072.

<sup>27</sup> *Ocampo* at 8.

<sup>28</sup> Pub. L. No. 105-353, 112 Stat. 3227 (1998).

<sup>29</sup> 15 U.S.C. § 77z-1(b)(4).

<sup>30</sup> *Ocampo* at 7-8.

<sup>31</sup> *Id.* at 8 (citing *Testa v. Katt*, 330 U.S. 386, 391 (1947); *Dice v. Akron, Canton & Youngstown R.R. Co.*, 342 U.S. 359, 363 (1952); *Monessen Sw. Ry. Co. v. Morgan*, 486 U.S. 330, 336 (1988)).

<sup>32</sup> *Id.* at 9.