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Supreme Court to Decide Whether PSLRA Discovery Stay Applies in State Court

A Supreme Court decision could resolve significant inconsistency among trial courts as to the applicability of the PSLRA discovery stay.

Key Points:

- While federal district courts have consistently applied the Private Securities Litigation Reform Act (PSLRA) automatic stay to halt discovery until a determination that the complaint states a viable claim for relief, state trial courts have been divided as to whether that stay applies to actions filed in state court.
- If the Supreme Court rules in favor of petitioners, securities plaintiffs will not be able to use state court as an end-run to impose discovery on defendants before stating a viable claim for relief.
- The scope of the PSLRA discovery stay has far-reaching implications for public companies and financial institutions that underwrite IPOs, which have been subjected to a wave of parallel federal-state securities litigation in recent years.

On July 2, 2021, the US Supreme Court granted certiorari in *Pivotal Software, Inc. v. Superior Court of California* on a critical issue of first impression at the federal appellate level: whether the PSLRA automatic stay of discovery pending a motion to dismiss in Securities Act cases applies to actions filed in state court.

Background

The Securities Act of 1933 provides certain private rights of action for materially false or misleading statements contained in securities registration statements. Principally, under Section 11 of the Securities Act, persons who purchased securities pursuant or traceable to a materially false or misleading registration statement may sue for statutory damages.[1] The Securities Act further provides that certain private actions, including those arising under Section 11, may be brought in either federal or state court.[2]

PSLRA Discovery Stay

In 1995, recognizing and seeking to curb abuses of the federal securities laws, including the Securities Act, Congress enacted the PSLRA. Among other things, the PSLRA mandated sanctions for frivolous litigation, imposed a heightened pleading standard for certain claims, created a "safe harbor" for forward-

looking statements, and — as relevant here — prohibited discovery until after a complaint has survived a motion to dismiss.[3]

The PSLRA's discovery stay applies broadly "[i]n *any private action*" arising under the Securities Act — language that plainly embraces actions filed in state court[4] (emphasis added). Yet state courts across the country have been sharply divided on whether to apply the stay. Even worse, courts from the same jurisdiction — particularly California and New York, where most Securities Act claims are filed — have reached conflicting conclusions, meaning that the question of whether the discovery stay applies has been determined on a court-by-court, if not case-by-case, basis.

Post-*Cyan* Securities Litigation

The inconsistent application of the discovery stay, among other perceived "advantages" for securities plaintiffs, has contributed to a wave of Securities Act lawsuits filed in state court, particularly after the Supreme Court ruled in *Cyan, Inc. v. Beaver County Employees Retirement Fund*[5] that such lawsuits cannot be removed to federal court. As commentators have noted, state court cases are more likely to lack merit than their federal counterparts — yet are increasingly likely to be filed because of leniency of state court rules, including allowing early discovery.[6] Stated plainly, securities plaintiffs are attracted to courts that decline to apply the discovery stay because the ability to take early, pre-answer discovery imposes significant costs upon defendants — a burden that often coerces defendants to settle unmeritorious claims.[7] These coercive tactics have significant downstream costs for companies that issue securities, and premiums for directors' and officers' liability insurance have skyrocketed.[8] And while the companies that issue securities often face a single post-IPO suit, the investment banks that underwrite securities offerings for numerous issuers face repeated suits in multiple jurisdictions across the country.

The Pivotal Case

In April 2018, Pivotal — a San Francisco-based cloud software development company — went public in a blockbuster IPO. More than a year later, the company lowered its going-forward revenue guidance, which caused its share price to fall. Hot on the heels of that stock drop, numerous securities class action lawsuits were filed in state and federal court against Pivotal, its directors, and the 15 financial institutions that underwrote the IPO (represented in the action by the authors), claiming misrepresentations in Pivotal's IPO registration statement and prospectus as well as material misrepresentations by Pivotal and its officers and directors following the IPO. The state court cases were stayed, while the federal case proceeded. On July 21, 2020, Judge Breyer of the Northern District of California dismissed the federal complaint in its entirety.[9] While the dismissal was without prejudice, the federal plaintiffs dropped their claims instead of attempting to amend them.

Only after the federal plaintiffs dropped their claims did the state plaintiffs move forward. Upon lifting the stay, the state court plaintiffs immediately served voluminous and burdensome discovery on the corporate defendants and the underwriters — well in advance of demurrer briefing or a hearing. Defendants argued that the PSLRA discovery stay applied in state court, since the legislation's discovery-stay provision applies "[i]n any private action arising under" the Securities Act.[10] The Superior Court ruled that the PSLRA discovery stay did not apply in state court. Defendants' petitions for review by the California Court of Appeal and the California Supreme Court were summarily denied.

Defendants then filed a petition for a writ of certiorari. The petition argued that the plain language of the PSLRA discovery stay applies to "any" action, not just those in federal court. The petition noted that state courts across the country are sharply divided on the issue and that this is a recurring issue of critical importance in the wake of *Cyan*. Further, the issue consistently evades review because it arises as a

provisional stay in state court, and would never realistically create an appealable issue from a final judgment even if a state court case were litigated to judgment. The Supreme Court granted the petition on July 2, 2021.

Next Steps and Potential Impact

The scope of the PSLRA discovery stay will now be briefed and argued in late 2021. If the Supreme Court holds that the discovery stay applies in state court, the Court will more closely align the rights of plaintiffs who file securities claims in federal court with the rights of those who file in state court (by preventing state court filers from taking discovery before adequately stating a claim for relief). Staying such discovery would not deter meritorious claims, because (as in federal court) discovery would commence as soon as a claim has been viably alleged. But applying the PSLRA discovery stay would prevent the use of early discovery to coerce defendants to settle unmeritorious claims and reduce plaintiffs' incentive to file unmeritorious claims in state court due to perceived procedural advantages. In the meantime, state court securities defendants should vigorously argue in favor of applying the PSLRA discovery stay and note the grant of certiorari when doing so.

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:

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Endnotes

[1] *See* 15 U.S.C. § 77k.

[2] *See Cyan, Inc. v. Beaver County Employees Retirement Fund*, 138 S. Ct. 1061, 1066 (2018).

[3] *See* 15 U.S.C. § 77z-1.

[4] *See* 15 U.S.C. § 77z-1(b).

[5] *See Cyan*, 138 S. Ct. 1061.

[6] *See* Michael Klausner et al., *State Section 11 Litigation in the Post*-Cyan *Environment (Despite* Sciabacucchi*)*, 75 The Business Lawyer 1769, 1775 (2020).

[7] *Id.* at 1781-82.

[8] *See* Carl E. Metzger & Brian H. Mukherjee, *Challenging Times: The Hardening D&O Insurance Market*, Harvard Law School Forum on Corporate Governance (Jan. 29, 2020).

[9] *In re Pivotal Sec. Litig.*, No. 3:19-CV-03589-CRB, 2020 WL 4193384 (N.D. Cal. July 21, 2020).

[10] *See* 15 U.S.C. § 77z-1(b)(1).