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Securities Law and the Supremacy Clause

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It is a well-established principle of federalism that federal law, whether procedural or substantive, applies in state court when federal law says so. The Private Securities Litigation Reform Act of 1995 (the "PSLRA") includes such a directive, mandating that all discovery must be stayed upon the filing of a motion to dismiss. Claims under the Securities Act of 1933 brought in state court, which the U.S. Supreme Court has found permissible, *see Cyan, Inc. v. Beaver County Employees Retirement Fund*, 138 S. Ct. 1061, 1073 (2018), are subject to the automatic discovery stay in the PSLRA. *See, e.g.*, *City of Livonia Retiree Health & Disability Benefits Plan v. Pitney Bowes Inc.*, No. X08FST-CV186038160S, 2019 WL 2293924, at *4 (Conn. Super. May 15, 2019). Some state courts have reached the opposite conclusion, but the discovery stay is mandatory, and the Supremacy Clause requires state courts to enforce the stay.

Reverse-*Erie*

The reverse-*Erie* doctrine answers the question of when federal law preempts state law in state court under the Supremacy Clause of the U.S. Constitution. The doctrine came into existence the very same day as its converse namesake, *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 64 (1938). In *Hinderlider v. La Plata River & Cherry Creek Ditch Co.*, 304 U.S. 92, 110 (1938), the U.S. Supreme Court held that federal common law, not state law, governed the process in a state court action over states' rights to interstate water. Since then, the application of the Supremacy Clause in this context has been clear: if Congress specifies a procedure for a particular federal claim, then federal procedural law reigns supreme in state courts. *See* U.S. Const. art. VI, cl. 2.

Congress can make federal law applicable in state courts both expressly and impliedly, and can preempt an entire field of law. Express preemption requires "explicit pre-emptive language," as seen in, among others, the Copyright Act, the Employee Retirement Income Security Act, the Airline Deregulation Act, and the Federal Aviation Administration Authorization Act. *See Gade v. Nat'l Solid Wastes Mgmt. Ass'n*, 505 U.S. 88, 115 (1992). Implied preemption, by contrast, applies in situations where state law conflicts with federal law or poses an unnecessary burden on, or stands as an obstacle, to federal purposes. Lastly, there are situations where federal law has preempted an entire field of law.

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Gade, 505 U.S. at 115 ("Field pre-emption is wrought by a manifestation of congressional intent to occupy an entire field.").

With this background in mind, we turn to the Securities Act of 1933, which gives state and federal courts concurrent jurisdiction.

City of Livonia is a sophisticated application of reverse-*Erie* doctrine to securities law.

The PSLRA provides as follows:

> In any private action arising under this subchapter, 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. § 77z-1(b)(1). Congressional reports explain the policy behind the automatic discovery stay. The House Conference Report accompanying the PSLRA stated that "the investing public and the entire U.S. economy have been injured by . . . baseless and extortionate securities lawsuits" and "abuse of the discovery process." H.R. Conf. Rep. 104-369, at 31–32 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 730, 731. The Senate Report also reflected this concern, highlighting testimony of "endless depositions for the slightest positive comment," and discovery costs so burdensome they "often force[] defendants to settle." S. Rep. 104-98, at 14 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 693. As a result, the Senate Subcommittee on Securities "determined that discovery should be permitted in securities class actions only after the court has sustained the legal sufficiency of the complaint." *Id.*

In *City of Livonia*, 2019 WL 2293924, at *6, the Superior Court of Connecticut granted a stay of discovery in state court pursuant to the PSLRA. The Court held that the conflicting Connecticut state procedure appropriately bowed to the federal statute. The defendants in that case framed the securities law issue in terms of Constitutional scholarship: "If a state court is hearing a case arising under federal law, must it also follow the federal procedures? If the federal law expressly specifies the procedures to be used with regard to a particular cause of action, then, *of course*, states must follow it." Reply Memorandum at 4, *City of Livonia*, 2019 WL 2293924 (No. 148.00) (quoting Erwin Chemerinsky, Federal Jurisdiction 231 (7th ed. 2016)). Congress spoke directly to this point "by *expressly* stating that the stay attaches 'in *any* private action arising under th[e Securities Act of 1933].'" *Id.* The Connecticut Superior Court agreed, specifically recognizing that in *Cyan*,

> [b]ecause the Supreme Court held that language identical to that at issue here applies to both state and federal actions commenced under the Securities Act, the inference is strong that [the PSLRA discovery stay] . . . is not ambiguous and that its plain meaning compels the conclusion that the statute, providing for a stay of discovery during the pendency of a motion to dismiss, applies to actions commenced in state court under the Securities Act, as well as such actions commenced in federal court.
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> *City of Livonia*, 2019 WL 2293924, at *4.

After *City of Livonia*, New York Supreme Court Justice Borrok adopted a similar Supremacy Clause argument and granted a discovery stay pending a motion to dismiss a Securities Act case pursuant to the PSLRA. *In re Everquote, Inc. Sec. Litig.*, 106 N.Y.S.3d 828 (N.Y. Sup. Ct. 2019). Justice Borrok explained:

> [M]ost importantly, this procedural/substantive distinction misses the point. The 1933 Act is a federal statute. It was Congress that created the specific rights covered by the 1933 Act including affording concurrent jurisdiction to state courts to adjudicate claims brought under the 1933 Act. This is not an issue of federal common law being applied to supply a rule of decision. Rather, this is a federal statute creating federal rules of decision that both state and federal courts are required to follow in deciding 1933 Act cases. It is axiomatic that Congress has the power under the United States Constitution, Article VI, Clause 2 (the Supremacy Clause) to provide for how these claims must be handled in state court which Congress has granted jurisdiction to hear these very federal claims.

Id. at 836; *cf. In re Dentsply Sirona, Inc. v. XXX*, No. 155393/2018, 2019 WL 3526142, at *1 (N.Y. Sup. Ct. Aug. 02, 2019) (Scarpulla, J.); *In re PPDAI Grp. Sec. Litig.*, 116 N.Y.S.3d 865 (N.Y. Sup. Ct. 2019) (Scarpulla, J.). Another New York Supreme Court Justice reached the same conclusion as Justice Borrok and the Connecticut Superior Court, though by means of different reasoning. In *Greensky, Inc. Securities Litigation*, No. 655626/2018, 2019 WL 6310525, at *1–2 (N.Y. Sup. Ct. Nov. 25, 2019) (Schecter, J.), discovery was "stayed pending determination of defendants' motion to dismiss" in order "to give effect to the PSLRA's policy of staying discovery until a plaintiff has demonstrated that its 1933 Act claims have merit." While Justice Schecter was "not convinced that the PSLRA, by its terms, expressly mandates a stay in state court," she found that "[t]he important purpose underlying enactment of the automatic stay—ensuring that cases have merit at the outset—should not be disregarded merely because a federal cause of action is being prosecuted in state court." *Id.* at *2. That is, even if the PSLRA's language, "in any private action," were not an example of express federal preemption, the states' conflicting permissive discovery procedures would frustrate Congress's intended policy of preventing "fishing expedition" discovery. That frustration of Congressional policy is an obstacle to federal purposes and results in implied preemption, requiring the state court to apply federal procedure (the identical outcome one would reach with express preemption).

The weight of authority (and the text of the PSLRA) mandates federal preemption. We recommend practicing attorneys in state court Securities Act cases moving to stay discovery pending resolution of a motion to dismiss follow the reasoning outlined in *City of Livonia* and *Everquote*. That is because "the state court should act in the same manner as federal courts do when applying state law under *Erie*. In both the reverse-*Erie* setting and the *Erie* setting, the court's job is to apply the other sovereign's 'existing' law, not to 'make' law for the other." Richard H. Field, Benjamin Kaplan, & Kevin M. Clermont, Materials for a Basic Course in Civil Procedure 461 (12th ed. 2017). Accordingly, state courts should not avoid the PSLRA's automatic stay directive by categorizing the directive as procedural and applying the state's own procedural laws. "The labels of procedure and substance are capable of manipulation and have

no bearing on the state court's task." Omar K. Madhany, Comment, *Towards a Unified Theory of "Reverse-*Erie*"*, 162 U. Pa. L. Rev. 1261, 1306 (2014). In a Securities Act case, the state court's task is to give effect to the PSLRA's clear, compelling, and controlling command, to stay discovery pending a motion to dismiss, and thus honor the policy goal of reducing the financial burdens of discovery in securities cases.