

**A Stay In A Federal Class Action
Does Not Necessarily Bar a Plaintiff's
State Law Claim for Books and Records**

By Lewis H. Lazarus and Thomas E. Hanson, Jr.

With the recent passage of federal legislation regulating public companies such as the Private Securities Litigation Reform Act of 1995 ("PSLRA"), the Securities Litigation Uniform Standards Act ("SLUSA"), and *Sarbanes-Oxley*, courts are increasingly called upon to examine the effect of those statutes on matters that traditionally were the domain of state law. In *Cohen v. El Paso Corp.*, C.A. No. 551-N, Chandler, C. (Del. Ch., Oct. 18, 2004), the Delaware Court of Chancery confronted whether the PSLRA or the SLUSA barred a plaintiff from pursuing a claim under § 220 of the Delaware General Corporation Law ("DGCL") to inspect the books and records of a Delaware corporation to investigate alleged waste and mismanagement. Following a careful analysis of the circumstances of plaintiff's demand, and the law of preemption, the Court held that neither the PSLRA nor the SLUSA barred plaintiff from pursuing his state law claim. In so holding, the Court preserved the ability of stockholders in a proper case to investigate claims of waste and mismanagement, notwithstanding a stay of discovery entered in prior-filed federal litigation arising out of virtually identical facts. At the same time, the *Cohen* decision makes clear that a plaintiff frustrated by a stay of discovery in federal litigation pursuant to the PSLRA or SLUSA cannot in bad faith use the DGCL to obtain discovery to pursue its federal claims.

**1. The Procedural Posture: Defendant Moves To Dismiss State Law
Claim Brought After Stay Of Discovery Entered In Federal Action**

The *Cohen* litigation arose from a prior-filed federal action. El Paso Corporation had moved to dismiss a putative class action filed in a federal court, and that motion triggered the automatic stay provision of the PSLRA. When plaintiff subsequently filed an action in Delaware to obtain books and records, El Paso moved to dismiss, arguing that the plaintiff's books and records action was brought in bad faith to circumvent the stay of discovery, and, in any event was preempted by such stay.

**2. Delaware Court of Chancery Finds Plaintiff Had Proper
Purpose In Seeking Books And Records To Investigate Alleged
Waste And Mismanagement**

The Court began its analysis of El Paso's motion by determining whether the plaintiff stated a proper purpose for its books and records request. In this context, the Court construed El Paso's claim of bad faith conduct as challenging the plaintiff's purpose as improper. As nothing "on the face of the complaint demonstrate[d] or even suggest[ed]" an improper purpose, and the plaintiff's stated purpose was amply supported by credible evidence, the Court rejected El Paso's claim that the plaintiff sought to circumvent the stay of discovery and obtain documents for use in the federal action.

In particular, the plaintiff's stated purpose for requesting El Paso's books and records was to investigate possible waste and mismanagement by the company. To obtain books and records on such grounds, the plaintiff must demonstrate a "credible basis" from which the Court can infer that waste and mismanagement has occurred. This standard was easily met where El Paso had publicly announced a \$1 billion write-down due to improper accounting practices and the SEC had launched an investigation of El Paso's accounting practices. Critical to the Court's determination of no improper purpose was its finding that plaintiff's counsel was neither connected to nor involved with counsel in the federal action. Its finding was bolstered by plaintiff's willingness to enter into a confidentiality agreement that would prevent plaintiff from disclosing the material he might obtain in Delaware pending resolution of the motion to dismiss in the federal action. Under these circumstances, the Court concluded that "nothing supports El Paso's assertion that [the Delaware plaintiff] is attempting to aid the plaintiffs in [the federal litigation] and thereby undermine the PSLRA's automatic stay of discovery."

3. The Court Holds That Plaintiff's Claim Is Not Barred By the Doctrine Of Preemption

In analyzing the preemption claim, the Court examined the purposes underlying the federal statutes to determine if the PSLRA or SLUSA either explicitly or implicitly preempted the § 220 action. The Court found that the Congress enacted the applicable statutes to curb abusive discovery practices and "to allow the parties to come to a conclusion on [motions to dismiss] free from the weight of potentially costly, and possibly wide-ranging discovery."

In applying the statutes to the plaintiff's § 220 action, the Court found that they nowhere expressly prohibited a state court from considering a demand for books and records against a corporation protected by a stay of discovery in an unrelated federal securities action. Although the plaintiff's books and records action alleged "similar, if not identical facts" as the federal action, the right to investigate claims of waste, mismanagement and breach of fiduciary duty relate to "traditional state law claims" not asserted in the federal action. According to the Court, a potential conflict that implicates preemption "will potentially arise only" where the records sought pertain directly to a federal securities law claim asserted in a pending federal action, which was not the case at bar. As such, "neither the PSLRA nor SLUSA operate to preempt or otherwise interrupt [the plaintiff's] § 220 action."

Conclusion

In *Cohen*, the Delaware Court of Chancery denied a defendant's attempt to prevent a plaintiff from pursuing a state law claim on the ground that plaintiff's claim was preempted by the PSLRA and/or SLUSA. The lack of evidence that the plaintiff in the Delaware action would use the requested books and records in furtherance of the federal action, including the Delaware plaintiff's willingness to enter into a confidentiality agreement that would prevent disclosure of any documents obtained in Delaware pending resolution of the motion to dismiss, gave the Delaware Court comfort that the state law

claim was not being pursued to frustrate the stay in the federal action. The case also suggests the outcome might have been different had the facts shown collusion between the Delaware plaintiff and the plaintiffs in the federal action. Notwithstanding recent federal legislation which regulates class actions, the *Cohen* decision makes clear that state laws such as the DGCL retain vitality for parties to class and derivative litigation.