Preservation of Electronic Information by Nonparties under the Private Securities Litigation Reform Act

By Mark A. Berman and Aaron E. Zerykier

Courts are frequently asked by parties to lift the automatic stay of discovery imposed under the Private Securities Litigation Reform Act (PSLRA) when an initial motion to dismiss is contemplated.[1] When such applications are made, courts are presented with the quandary of whether to issue a preservation order or, alternatively, to rely upon a party's obligations under the PSLRA, the Federal Rules of Civil Procedure, and the common law to preserve and not "spoil" relevant information, as well as upon an attorney's representation that relevant materials will be preserved.

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Notably, the PSLRA's obligations regarding preservation do not extend to nonparties to an action. However, both plaintiffs and defendants often have reason to be concerned that relevant evidence in the possession of nonparties may be lost or destroyed. Parties must then obtain leave of court in order to secure the preservation, let alone the production, of such materials from nonparties while the PSLRA's automatic stay of discovery is in place.

The Intent of the PSLRA

"Congress enacted the PSLRA to redress certain perceived abuses in securities class actions, including the abuse of the discovery process to coerce settlement."[2] The purpose of the automatic stay under the PSLRA is "to minimize the incentives for plaintiffs to file frivolous securities class actions in the hope either that corporate defendants will settle those actions rather than bear the high cost of discovery, *see H.R. Conf. Rep. No. 104-369*, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 736, or that the plaintiff will find during discovery some sustainable claim not alleged in the complaint, *see S. Rep. No. 104-98*, at 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 693."[3]

The PSLRA provides that:

> [i]n any private action arising under this chapter 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.[4]

However, the PSLRA "in recognition that the imposition of a stay of discovery may increase the likelihood that relevant evidence may be lost" includes a provision requiring the preservation by a party of discovery material.[5] The preservation provision of the PSLRA provides that:

> [d]uring the pendency of any stay of discovery pursuant to this paragraph, unless otherwise ordered by the court, any party to the action with actual notice of the allegations contained in the complaint shall treat all documents, data compilations (including electronically recorded or stored data), and tangible objects that are in the custody or control of such person and that are relevant to the allegations, as if they were the subject of a continuing request for production of documents from an opposing party under the Federal Rules of Civil Procedure.[6]

Nonparty preservation subpoenas may be "necessary" "when the non-party does not have actual notice of the litigation or when the non-party is a corporate entity which typically destroys electronic information by performing routine electronic backup procedures."[7]

Under the PSLRA, a party, however, may only be awarded sanctions when it is "aggrieved by the *willful failure* of an *opposing party* to comply" with the requirement to preserve evidence.[8] Significantly, however, the PSLRA offers no protection to an aggrieved party when a nonparty fails to preserve relevant information.

Preservation of Information by Nonparties

In order to require a nonparty to preserve electronic information, a party will need to obtain jurisdiction[9] over such nonparty through the issuance of, at a minimum, a preservation subpoena. However, to serve such a subpoena, a party first must seek relief from the court of the automatic stay under the PSLRA.[10] To obtain such relief, a party must (1) request "particularized discovery" and (2) "show that such discovery is necessary either to preserve evidence or to prevent undue prejudice to that party."[11] Courts have lifted stays where, for instance, "defendants might be shielded from liability in the absence of the requested discovery."[12]

Instead, however, of requiring a showing that a preservation order is necessary to preserve information, a "party may show that absent the preservation subpoena the party will suffer undue prejudice."[13] "Undue prejudice" has been defined as "improper or unfair treatment amounting to something less than irreparable harm."[14]

But the ever present issue is what a court should require a plaintiff to allege in order to justify its lifting of the PSLRA's automatic stay of discovery to require a nonparty to preserve electronic materials.

The decision in *In re Triton Energy Ltd. Securities Litigation* serves as an excellent case study.[15] In *Triton*, former directors, including the chief executive officer, during a sub-

stantial period in which the action was pending, testified that they had not been asked by the company's counsel to produce, let alone retain, relevant documents. There was also testimony that relevant emails had been sent and received by a former director and that emails were retained on the company's email server for one year before being destroyed (and therefore were in existence at the time the suit was filed) but were no longer in existence at the time of the director's deposition.[16]

The defendant corporation had informed its employees to preserve and not to destroy certain types of documents, including materials in electronic form, but it did not so advise its outside directors, taking the position that such directors were not employees and that it did not have control over the personal computers of former directors.[17] In addressing the duty of outside directors to preserve information, the court indicated that

> it would have been prudent and within the spirit of the law for Triton to instruct its officers and directors to preserve and produce any documents in their possession, custody, or control. As stated above, the Court does not find that Triton *intentionally* failed to instruct the outside directors to preserve and produce relevant documents. . . . At the same time, it is clear that as a result of the failure to implement a suitable document preservation plan, to communicate that plan effectively to [outside directors], and to follow up to insure that the directive was being followed, there were holes in the document preservation plan through which discoverable materials may have been lost.[18]

Nevertheless, the court granted in part plaintiffs' application and appointed a forensic computer specialist to

> retrieve the information from the Triton's computer storage systems (including servers and hard drives) and those of all former officers and directors as well as all present and former members of the Board of Directors. . . . The computer specialist will conduct non-destructive testing of these systems to determine what documents and e-mails, if any, have been deleted. The special master would then review and determine what documents and electronic data, if any, were destroyed that bear significantly on the claims and defenses in this lawsuit.[19]

In *Tyco*, while a preservation order was not issued against defendants,[20] the court did lift the automatic stay to permit the issuance of "appropriately tailored preservation subpoenas on specified third parties [ ] necessary to preserve evidence."[21] The court noted that the third parties were mainly accountants, auditors, and/or consultants who may possess relevant documents.[22] The court also noted that, unlike the defendants, such nonparties have not necessarily received actual notice of the action, and therefore a preservation order was appropriately requested. Significantly, the court found that plaintiffs "produced evidence that large corporations typically overwrite and thereby destroy electronic data in the course of performing routine backup procedures [and plaintiffs] therefore offered more than ungrounded speculation that relevant evidence may be destroyed."[23] The court further found that the issuance of preservation subpoenas was warranted because, in accordance with the PSLRA, the plaintiff would suffer "undue prejudice," which the court construed as meaning an "improper or unfair detriment." Such a finding was predicated upon plaintiff's showing that evidence relevant to such claims might be inadvertently destroyed by third parties who did not have notice of the action.[24]

In *National Century*,[25] the court lifted the automatic stay and authorized the issuance of a preservation subpoena directed against a company that was liquidating in bankruptcy and had sold its assets and assigned most of its contracts and leases to one of its wholly owned subsidiaries. The court found that there were "potentially . . . documents and information relating to Plaintiff's claims . . . which are currently in the possession of [such nonparty] and may no longer be available unless preserved."[26] The court held that

> plaintiffs have shown that the preservation subpoena is necessary to preserve the documents held by [the nonparty]. [The nonparty] is currently undergoing Chapter 11 bankruptcy and will likely be dissolved. Accordingly, the documents held by [the nonparty] will likely be destroyed. The destruction of the documents and electronic information currently held by [the nonparty] will likely cause actual prejudice to the Plaintiffs as the [nonparty] was an integral participant in the claims that Plaintiffs have asserted.[27]

In *Sedona*, the court concluded that a lifting of the stay was unnecessary.

In *Sedona*,[28] after a decision on defendant's first motion to dismiss had been issued, but before a second motion to dismiss had been made, plaintiff sent preservation letters to 10 nonparty broker dealers as well as serving a document subpoena on an additional nonparty. In addition, plaintiff made a motion to lift the PSLRA automatic stay of discovery to permit it to serve additional document subpoenas. The court concluded that a lifting of the stay was unnecessary as the court did "not perceive any risk of loss of evidence or substantial prejudice to plaintiff if the PSLRA discovery remains in effect" because the preservation letters had already been sent to the nonparties.[29]

Conclusion

In sum, a practitioner needs to be cautious when confronting the PSLRA's automatic stay of discovery. The PSLRA only applies to parties. Therefore, an attorney should attempt to ensure that nonparties in possession of relevant materials refrain from destroying or spoiling evidence. As such, an application seeking an order permitting a partial lifting of the

automatic stay would need to be made to authorize the issuance and service of preservation subpoenas on appropriate nonparties, which might include outside directors.

Such an application needs to demonstrate that, absent the preservation subpoena, the moving party will suffer undue prejudice and that the subpoena is required to preserve evidence. A preservation letter can also be sent to a nonparty, but caution should be used because the sending of such a letter could result in a court ruling that its receipt by the nonparty obviates the need for the partial lifting of the PSLRA automatic stay of discovery, as such nonparty is now on notice of the litigation and that some type of a duty to preserve, as a result, had been implicated.

Counsel also need to ensure that their clients take appropriate measures to protect materials from spoliation. This is especially true with electronic materials, which, as the courts have noted, are often overwritten or destroyed in the ordinary course of a company's business practice. Outside directors, as well as contract employees and consultants, should be directed to preserve electronic materials, as a court could find that such individuals are under the control of the corporation, and therefore subject to the PSLRA's obligations to preserve electronically stored materials.

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1. *See, e.g.,* Sedona Corp. v. Landenburg Thalmann, 2005 WL 2647945, *2 n.1 (S.D.N.Y. Oct. 14, 2005) ("[T]here is no dispute that the PSLRA stay of discovery applies when an initial motion to dismiss is contemplated, but has not yet been filed."). *See also In re* JDS Uniphase Corp. Sec. Litig., 238 F. Supp. 2d 1127, 1133 (N.D. Cal. 2002) (although motion to dismiss was not pending and time to respond to complaint had not run, PSLRA automatic stay of discovery was in effect); *In re* Carnegie Int'l Corp. Sec. Litig., 107 F. Supp. 2d 676 (D. Md. 2000) (same).
2. *In re* Tyco Inter., Ltd. Sec. Litig., 2000 WL 33654141, at *1 (D.N.H. July 27, 2000) (citation omitted).
3. *In re* WorldCom, Inc. Sec. Litig., 234 F. Supp. 2d 301, 305 (S.D.N.Y. 2002).
4. 15 U.S.C. § 78u-4(b)(3)(B).
5. *Tyco*, 2000 WL 33654141, at *1 (citations omitted).
6. 15 U.S.C.A. § 78u-4(b)(3)(C)(i). In addition to the preservation requirement under the PSLRA, parties have an obligation to preserve evidence that they "know [ ], or should know, may be relevant to actual or foreseeable litigation." Taft v. Ackermans, 2005 WL 850916, at *5 (S.D.N.Y. Apr. 13, 2005). Further, a court may sanction a party for failure to preserve evidence, pursuant to Rule 37(b) of the Federal Rules of Civil Procedure and its inherent sanctioning power. *See id.*
7. *See In re* Nat'l Century Fin. Enter., Inc. Fin. Inv. Litig., 347 F. Supp. 2d 538, 542 (S.D. Ohio 2004) (citations omitted).
8. *See* 15 U.S.C.A. § 78u-4(b)(3)(C)(ii) (emphasis added).
9. In Ferrari v. Gisch, 225 F.R.D. 599, 611–12 (C.D. Cal. 2004), the court denied the issuance of a preservation order even though, among other things, plaintiffs asserted that the assets of the subject company might be sold to third parties and, that once sold, counsel for the defendants would have no authority over the third party to require it to preserve evidence. The court rejected this argument indicating that only parties are subject to the PSLRA and further noted that it was unclear whether the court could exercise jurisdiction over third-party witnesses or potential purchasers. The court also denied plaintiff's request for an order mandating that the defendants preserve evidence because "defendants represent[ed] that they have complied and will comply with the statute and [because] plaintiffs adduced no evidence of non-compliance." *Id.* at 611.
10. *See Nat'l Century*, 347 F. Supp. 2d at 541–42.
11. *Id.*
12. Vacold LLC v. Cerami, 2001 WL 167704, at *6 (S.D.N.Y. Feb. 16, 2001) (citing Global Intellicom, Inc. v. Thomson Kernaghan & Co., 1999 WL 223158, at *2 (S.D.N.Y. Apr. 16, 1999) (lifting the stay where plaintiff's redress would be foreclosed absent discovery)).
13. *Nat'l Century*, 347 F. Supp. 2d at 542.
14. *In re* Vivendi Universal, S.A., 381 F. Supp. 2d 129, 130 (S.D.N.Y. 2003) (internal quotation omitted). *See* Med. Imaging Ctrs. of Am., Inc. v. Lichtenstein, 917 F. Supp. 717, 721 (S.D. Cal. 1996) (finding that "[t]he legislation by its terms does not carve out specific types of actions which will be exempt from the stay," but noting that "the 'undue prejudice' exception contemplates an analysis of the facts and circumstances surrounding a request for an exception to the mandated discovery stay").
15. *In re* Triton Energy Ltd. Sec. Litig., 2002 WL 32114464 (E.D. Tex. Mar. 7, 2002).
16. *Id.* at *3.
17. *Id.* at *4. This position would require in every litigation that a party seek permission from the court to serve each outside director of a company with a preservation subpoena. This could well result, however, in an objection from the company's counsel, and an admonishment from the court, that such application was unnecessary as outside directors are under the control of the company. Yet, under *Triton*, if such a request had been made by the plaintiff at the commencement of the action, it may well have eliminated significant subsequent motion practice. In addition, if the counsel for the party requesting such discovery contacted and/or sought documents directly from an outside director, taking the position that the director was not represented by the company's counsel, such an action would likely be met by a complaint that this conduct was ethically prohibited.
18. *Id.* at *6 (emphasis in original) (internal citations omitted).
19. *Id.*
20. *See, e.g., Tyco*, 2000 WL 33654141, at *2 ("[a]bsent a showing that defendants are not acting in accordance with their statutory duty, the PSLRA's preservation provision should be sufficient to ensure the preservation of relevant evidence in the defendants' custody or control," where defendants were on actual notice of the allegations and the documents and data sought and defendants' counsel had entered into an agreement regarding the types of documents to be preserved).
21. *Id.* at *3.
22. *Id.*
23. *Id.*
24. *Id.* at *4.
25.*Nat'l Century*, 347 F. Supp. 2d at 538
26. *Id.* at 540.
27. *Id.* at 542.
28. *Sedona*, 2005 WL 2647945.
29. *Id.* at *4.