Legal Opinion Letter

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A REASONED APPROACH TO SANCTIONS UNDER THE SECURITIES ACT OF 1933

by
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In the *Enron* litigation, District Court Judge Melinda F. Harmon recently granted defendant Alliance Capital Management, L.P.'s ("Alliance") motion for summary judgment and for attorneys' fees and costs under Section 11(e) of the Securities Act of 1933. *In re Enron Corp. Secs., Derivative & ERISA Litig.*, 463 F. Supp. 2d 628 (S.D. Tex. 2006). The court took the position that plaintiffs' *counsel*, not the plaintiffs themselves, should pay the award. *Id*. at 636. This ruling raises the issue of whether Section 11(e) authorizes courts to require counsel to bear some responsibility for asserting frivolous claims or defenses.

Background. In *Enron*, investors sued Alliance and one of its employees and directors, Frank Savage, who was also an Enron director. The only issue at summary judgment was whether Alliance was liable as a "controlling person" under Section 15 of the Securities Act.

Savage testified that Alliance did not control his activities or conduct as an Enron director and was not involved in his decision to sign the registration statement at issue. *Id*. Savage also testified that he was not aware of Alliance's benefiting as a result of his service on Enron's board. *Id*. at 637. The court granted summary judgment against the plaintiffs, holding that "Plaintiffs fail[ed] to plead and to prove any specific facts sufficient for a reasonable jury to conclude that Alliance was a control person." *Id*. at 642.

The court then undertook its Section 11(e) analysis. Section 11(e) provides that where judgment is "rendered against a party litigant" in a suit under the Securities Act, the court has discretion, "upon the motion of the other party litigant," to award the latter

> the costs of such suit, including reasonable attorney's fees . . . if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs.

15 U.S.C. § 77k(e).

Applying Section 11(e) in the Fifth Circuit, a court must find that the suit or defense is without merit, borders on the frivolous, or has been brought in bad faith. 463 F. Supp. 2d at 635. Judge Harmon found that when the suit was filed, "given the sophisticated concealment of Enron's financial condition, Plaintiffs' suspicions arising from Savage's dual-hat roles at Alliance were not

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unreasonable." *Id*. at 645. She concluded, however, that "the summary judgment briefing should not have been necessary and the continuance of the claim . . . was at that point without merit." *Id*. Accordingly, she awarded Alliance its attorneys' fees and costs for that stage of the litigation.

In considering whether plaintiffs' counsel should pay the award, Judge Harmon declined to follow the Second Circuit. *Id*. at 636 (citing *Healey v. Chelsea Resources, Ltd.*, 947 F.2d 611, 624 (2d Cir. 1991)). In *Healey*, the Second Circuit reversed a district court's ruling that Section 11(e) authorizes an award against counsel. While the court in *Healey* recognized that Section 11(e) was created to provide "a deterrent against 'blackmail suits' and against baseless defenses to meritorious claims," the court based its decision on the statute's plain language. 947 F.2d at 624. The court focused on Section 11(e)'s lack of an express provision allowing for sanctions against counsel. *Id*. The court also pointed to language calling for costs to be taxed in the "manner usually provided," which the Second Circuit interpreted to be against parties. *Id*. Finally, the court relied on the phrase "assess costs *against either the plaintiff or the defendant*" in the legislative history to find that Section 11(e) does not impose liability on a party's counsel. *Id*. at 625 (citation omitted).

In rejecting *Healey*, the Court held that it was more appropriate for counsel to bear the cost of an award because non-attorney clients would not be in a position to determine at what point an action becomes legally frivolous, whereas "licensed counsel should and is held to such a standard." 463 F. Supp. 2d at 636.

Analysis. Judge Harmon's ruling triggered a back-and-forth between *The Wall Street Journal* and plaintiffs' counsel, Bill Lerach,[1] but the real debate has yet to be resolved. The Fifth Circuit will not review Judge Harmon's ruling because Alliance has reportedly given up its right to fees and costs in exchange for plaintiffs' agreement to forgo an appeal. *See* WALL ST. J., *Lerach's Triumph*, Dec. 22, 2006, at A12.

Other than *Healey* and *Enron*, there is scarce case law on this issue. A district court opinion that was overruled by *Healey — Rubin v. Long Island Lighting Co.*, 576 F. Supp. 608, 616 (E.D.N.Y. 1984) — reached a conclusion similar to Judge Harmon's, largely based on policy reasons.[2] The court in *Rubin* recognized that Section 11(e)'s purpose was to deter strike suits. 576 F. Supp. at 615 (citation omitted).[3] After granting the defendant's motion to dismiss, the court held the plaintiffs' counsel, who had considerable securities litigation experience, "jointly and severally" liable for a fee award under Section 11(e). *Id*. at 616. In holding counsel partially responsible, the court relied heavily on the fact that the case was brought as a class action. *Id.* at 616 n.12. As a consequence, the court held that counsel "should share the responsibility for moderate attorneys' fees incurred in defending this suit which should have never been brought." *Id*.

The policy reasons outlined in *Enron* and *Rubin* are consistent with Section 11(e)'s purpose, especially in cases where counsel is calling the shots. The court in *Healey* did not face the dilemma of sanctioning a class representative. If it had, the Second Circuit might not have read Section 11(e) so narrowly, limiting the statute's deterrent effect in the class action context.

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[1]Editorial, *Lerach's Triumph*, WALL ST. J., Dec. 22, 2006, at A12; Editorial, *Loser Pays*, Wall St. J., Dec. 7, 2006, at A18; Peter Lattman, *Lerach's Enron Lawsuit Against AllianceBernstein Is Dismissed*, WALL ST. J., Dec. 2, 2006, at B3.

[2]Another court, relying on *Rubin*, also appeared to have required counsel to pay sanctions under Section 11(e). *Wielgos v. Commonwealth Edison Co.*, 123 F.R.D. 299, 306 (N.D. Ill. 1988) (applying Federal Rule of Civil Procedure rule 11 and Section 11(e)). A later decision, however, casts some doubt on whether the court believed Section 11(e) applied to its sanction against counsel. *See Wielgos v. Commonwealth Edison Co.*, 127 F.R.D. 135, 145 n.19 (N.D. Ill. 1989).

[3]In a similar effort to deter strike suits, the Private Securities Litigation Reform Act contains a provision requiring courts to undertake an analysis under Federal Rule of Civil Procedure rule 11 at the conclusion of a case. *See* 15 U.S.C. § 78u-4(c).

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