New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

Web address: http://www.law.com/ny

VOLUME 229—NO. 57

WEDNESDAY, MARCH 26, 2003

SECOND CIRCUIT REVIEW

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Rule 11 Sanctions, Subject Matter Jurisdiction

WE DISCUSS here two significant decisions recently issued by the U.S. Court of Appeals for the Second Circuit. In the first decision, the Second Circuit, deciding an issue of first impression, ruled that the applicable mens rea standard for sua sponte sanctions under Rule 11(b)(3), where there is no opportunity for the lawyer to withdraw the challenged statement, is subjective bad faith, not objective unreasonableness. In the second decision, the court followed its established tests for subject matter jurisdiction over transnational securities frauds, holding that a securities fraud masterminded and primarily taking place inside the United States fell well within the reach of the United States securities laws.

1) Rule 11 Sanctions

In *In re Pennie & Edmonds LLP*,[1] the Second Circuit, in an opinion written by Judge Jon O. Newman and joined by Judge Fred I. Parker, vacated a sanctions order imposed sua sponte by the district court on a law firm for violating Rule 11(b)(3) of the Federal Rules of Civil Procedure by submitting an affidavit without an objectively reasonable belief as to the truth of the affidavit. In so doing, the court ruled that the proper mens rea standard for post-trial sua sponte sanctions under Rule 11(b)(3) is subjective bad faith, not objective reasonableness. Judge Stefan R. Underhill, United States District Judge for the District of Connecticut sitting by designation, dissented.

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The sanction issue before the court arose from a trademark litigation, *Patsy's Brand, Inc. v. I.O.B. Realty, Inc.*, concerning the marketing of pasta sauce. One issue in the trademark litigation was the date on which defendants had begun using allegedly infringing labels on their products. Initially, defendants had contended that their date of first use was 1993 and supported their contention with two documents: a purported example of the allegedly infringing label in 1993, and a purported invoice from a printer showing that the label had been printed in 1993. Other evidence destroyed the probative value of the documents, and ultimately defendants disclaimed reliance upon them. Thereafter, the district court granted plaintiff's motion for preliminary injunction.

After the injunction issued, Pennie & Edmonds (P&E) appeared for defendants. Two P&E partners questioned defendants about their prior submission of the fraudulent documents. One defendant responded that, while the submitted label had in fact been used in 1999, not 1993, a similar label had been used in 1993. Defendant also asserted that, after the fraudulent invoice had been submitted, the printer had told him that he was unable to locate the original invoice and thus, without defendants' knowledge, re-created it. Defendant showed the P&E partner an affidavit from the printer to that effect. Additional doubts about defendant's explanations later surfaced: the 1999 label alleged to be similar to the 1993 label bore a trademark registered years after 1993 and the printer stated that, if subpoenaed, he would testify that he had not done any business with defendants in the relevant time period. Again, the P&E lawyers questioned defendants, and, again, defendants insisted their explanations had been true.

Plaintiff subsequently moved for summary judgment. In opposition, P&E submitted an affidavit from defendant repeating his explanation for the submission of the fraudulent documents. The district court granted summary judgment for plaintiff and, in so doing, expressed the court's view that defendant's explanation was false. In the same decision, the court sua sponte ordered P&E to show cause why the firm should not be sanctioned under Rule 11 for permitting the submission of the false affidavit. In response, P&E detailed the steps taken to investigate the veracity of the explanations and defendant's repeated insistence that the explanations were truthful.[2]

In an opinion and order entered Jan. 17, 2001, the district court, while accepting the firm's assertion that it had acted in subjective good faith, nevertheless sanctioned P&E under Rule 11 for permitting defendants to file an affidavit containing statements that the law firm could not have objectively believed were true. The sanction order was stayed pending appeal. On appeal, P&E argued that the district court had erroneously applied an objective unreasonableness standard instead of applying the more exacting standard of subjective bad faith.

The Second Circuit

At the outset of its discussion, the Second Circuit explained that, in 1993, Rule 11 was amended in two respects. First, the certification standard based on written factual contentions was changed to require certification that "to the best of the person's knowledge, information and belief, formed after an inquiry reasonable under the circumstances, … (3) the allegations and other factual contentions have evidentiary support." Second, Rule 11 was amended to include a "safe harbor" provision allowing the lawyer an opportunity to withdraw or correct a challenged submission. The safe harbor provision delays filing of a motion for sanctions before the court for 21 days after service and then may be filed only if the challenged submission is not withdrawn or appropriately corrected. Courts consider such a motion untimely if filed too late to permit correction or withdrawal.

As the Second Circuit noted, Rule 11 contains no safe harbor opportunity with respect to a sanction proceeding initiated by a court sua sponte. Indeed, the drafters of Rule 11 had expressed their view that, because of the absence of the safe-harbor, "court-initiated sanction proceedings would be used only in more egregious circumstances" — those "akin to a contempt of court." As a result, the court urged that sua sponte Rule 11 sanctions must be reviewed with "particular stringency" and noted that the proper mens rea standard in such circumstances was an issue that had not "explicitly [been] ruled on" by the Second Circuit.[3]

Examining the appropriate mens rea at issue, the court explained first that "the mental state applicable to liability for Rule 11 sanctions initiated by motion is objective unreasonableness, i.e., liability may be imposed if the lawyer's claim to have evidentiary support is not objectively reasonable" — a standard the court deemed appropriate "in circumstances where the lawyer whose submission is challenged by motion has the opportunity, afforded by the safe harbor provision, to correct or withdraw the challenged submission." But the court found support for P&E's argument that "the more rigorous standard of bad faith should apply" to court-initiated proceedings. First, the advisory committee to Rule 11 held a clear expectation that court-initiated sanction proceedings will ordinarily be used only in circumstances akin to contempt. Thus, the Second Circuit's prior rulings that "a finding of bad faith on the part of the attorney is essential to a finding of contempt" provide "strong support for the proposition that, when applying sanctions under Rule 11 for conduct that is 'akin to a contempt of court,' a bad faith standard should apply."[4]

When Regime 'Too Severe'

Moreover, recognizing that "any regime of sanctions for a lawyer's role in the course of representing a client inevitably has implications for the functioning of the adversary process," the court advised that if "the sanction regime is too severe, lawyers will sometimes be deterred from making legitimate submissions on behalf of clients out of apprehension that their conduct will erroneously be deemed improper" but "on the other hand, if the sanction regime is too lenient, lawyers will sometimes be emboldened to make improper submissions on behalf of clients, confident that their misconduct will either be undetected or dealt with too leniently to matter." Finding that the 1993 amendments to Rule 11 "strike a sensible balance" by "making a lawyer sanctionable for an objectively unreasonable submission" while "at the same time affording the lawyer a safe harbor," the court ruled that the absence of such a safe harbor — as in the case of sanctions being imposed sua sponte — risks chilling the adversary process by prompting lawyers to withhold submissions that have plausible evidentiary support "for fear that a trial judge … will erroneously consider their claimed belief to be objectively unreasonable."[5]

The court dismissed assertions that acts in New York did not suffice for jurisdiction because the acts directly causing harm to investors occurred in Bermuda.

Thus, because a "vigorous adversary process is better served by avoiding the inhibiting effect of an objectively unreasonable standard applied to unchallenged submissions, and letting questionable evidence be tested with cross-examination and opposing evidence," the court concluded that it "is better to apply a heightened mens rea standard to unchallenged submissions and take the slight risk with respect to such submissions that, on occasion, a jury will give unwarranted weight to a few submissions that a judge would consider objectively unreasonable. …"

Notwithstanding its view that it is "arguable" "that a 'bad faith' standard should apply to all court-initiated Rule 11 sanctions because no safe harbor protection is available and because the Advisory Committee contemplated such sanctions for conduct akin to contempt," the Second Circuit declined to "make so broad a ruling" and limited its holding to circumstances such as those presented in the case at bar — namely, where the sanction was initiated by the district court long after P&E had an opportunity to correct or withdraw the challenged submission. Because the district court "accepted P&E's representation that its lawyers acted with subjective good faith," the Second Circuit vacated the Rule 11 sanction.

The Dissent

In his dissent, Judge Stefan Underhill accused the majority of turning back the clock by requiring a finding of subjective bad faith — a standard, according to the dissent, long-abandoned by the drafters of the amended Rule 11. Further, the dissent found no support for the majority's holding in the text of Rule 11, arguing that its plain meaning demonstrates that a "single mens rea" — objective unreasonableness — applies to all sanctionable conduct, whether proceedings are initiated on motion or by the court. Nor did the dissent find support for the court's holding in the advisory committee notesto Rule 11, saying that the "panel should not su stitute its judgment for that of the Advisory Committee."

2) Jurisdiction

In *Securities Exchange Commission v. Berger*,[6] the Second Circuit, in an opinion written by Judge Jose A. Cabranes and joined by Judge Ellsworth A. Van Graafeiland and Judge Dennis Jacobs, affirmed the district court's grant of summary judgment to the SEC, rejecting defendant's argument that the securities fraud at issue was beyond the purview of the United States securities laws.

Defendant Berger was the founder of Manhattan Investment Fund Ltd. (the fund), an offshore investment company organized under the laws of the British Virgin Islands and designed for foreign investors and tax-exempt domestic investors. The fund began its trading operations in the spring of 1996, investing primarily in publicly traded securities. Only a small percentage of the fund's investors were located in the United States. Mr. Berger was the fund's only active director. An entity called Manhattan Capital Management Inc. (MCM) — a Delaware corporation headquartered in New York with Mr.

Berger as its sole officer and shareholder — served as investment adviser to the fund. The fund maintained a brokerage account at a broker-dealer located in Columbus, Ohio, which cleared its transactions through Bear Stearns in New York. The majority of the fund's assets and securities were held in the Bear Stearns account.[7]

Pursuing a strategy of short selling stocks on domestic securities exchanges, the fund suffered losses of over $300 million between 1996 and 2000. Mr. Berger, working from New York, created fraudulent account statements, which failed to report the losses and "vastly overstated the market value of the Fund's holdings." Every month for over three years, Mr. Berger forwarded the fraudulent statements from New York to the fund administrator in Bermuda. At Mr. Berger's instruction, the administrator relied on the fraudulent reports in calculating the net asset value of the fund each month. Those calculations, in turn, were reflected in the fund's monthly account statements sent to investors and in the fund's annual financial statements created at MCM's offices in New York.[8]

In January 2000, Mr. Berger revealed to the fund administrator that his calculations were based on misrepresentations and that the fund had suffered significant losses. Subsequently, Mr. Berger sent a letter to all shareholders advising them of the same. Several days later, the SEC filed an action against Mr. Berger, alleging violations of §17 of the 1933 Act, §10(b) of the 1934 Act and Rule 10b-5 and §206 of the Investment Advisers Act of 1940. In August 2000, the United States Attorney's Office for the Southern District of New York commenced a criminal proceeding against Mr. Berger. In November 2000, Mr. Berger pleaded guilty to securities fraud charges under §10(b) and Rule 10b-5, admitting to his misconduct during the plea allocution.

Based largely on Mr. Berger's admissions during his plea allocution, the SEC filed a motion for summary judgment in its civil action in July 2001.[9] Opposing the motion, Mr. Berger argued that the district court "lacked subject matter jurisdiction over the civil action because it involved extraterritorial conduct that did not directly result from acts occurring within the United States and that did not have an effect on U.S. residents or U.S. markets." Granting the SEC's motion for summary judgment, the district court determined that it had subject matter jurisdiction over the case, because the fraud — conceived and executed in New York — was run from the United States and directly caused the investor losses, and that the SEC had offered sufficient evidence of Mr. Berger's liability. Mr. Berger appealed, challenging solely the district court's ruling that it had subject matter jurisdiction over the action. Immediately after filing his appeal and prior to his sentencing, Mr. Berger fled the United States.

The SEC's Arguments

At the outset, the SEC argued that the appeal should be dismissed pursuant to the "fugitive disentitlement" doctrine, under which the federal courts "have authority to dismiss an appeal or writ of certiorari if the party seeking relief is a fugitive while the matter is pending."[10] Considering the "most persuasive justifications for disentitlement" in civil appeals — the inability to enforce a decision rendered by the appellate court and the need to avoid prejudice to the other party resulting from the appellant's fugitive status — the court found no prejudice to the SEC in light of Mr. Berger's uncontested admissions and concluded that an analysis of whether any decision rendered would be unenforceable with Mr. Berger at large and require additional fact-finding, which the court found "unnecessary" because his appeal was without merit. The court thus proceeded directly to the jurisdictional question.[11]

Acknowledging that "the various statutes governing securities exchanges, [are] silent as to [their] extraterritorial application," the Second Circuit confirmed, as its prior decisions make clear, that "subject matter jurisdiction may extend to claims involving transnational securities frauds." In evaluating whether the exercise of subject matter jurisdiction over such claims is proper, the Second Circuit considers: (1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens — known, respectively, as the "conduct test" and the "effects test."

Turning first to the "conduct test," the court counseled that the "test is met whenever (1) the defendant's activities in the United States were more than merely preparatory to a securities fraud conducted elsewhere and (2) the activities or culpable failures to act within the United States directly caused the claimed losses."[12] Rejecting Mr. Berger's argument that his conduct was "merely preparatory" and that the actions taken by the fund administrator in Bermuda constituted the "heart of the fraud," the court concluded that "subject matter jurisdiction clearly exists over Berger's actions," because "the fraudulent scheme was masterminded and implemented by Berger in the United States," with many acts materially related to the fraud occurring in the United States such as the creation of the false financial information, and transmission of the false information overseas.[13]

Directly Causing Harm

In so concluding, the court dismissed Mr. Berger's assertion that his actions — even if more than preparatory — did not suffice for jurisdiction to lie because "the activity directly causing harm to investors occurred in Bermuda," finding instead that "the fraudulent conduct was carried out entirely by Berger in New York" and that "[a]lthough the statements that ultimately conveyed the fraudulent information to investors were prepared and mailed in Bermuda … the fund administrator was simply acting under Mr. Berger's instruction in preparing the monthly account statements, which provided a means for Mr. Berger to distribute false information that he had already fraudulently concocted in the United States."[14]

Having concluded that jurisdiction was proper under the conduct test, the court — having "no doubt that the effects of Mr. Berger's actions were felt substantially in the United States" — saw no need to analyze the matter under the effects test. Accordingly, the court affirmed the district court's judgment of liability.

(1) No. 02-7177, 2003 WL 1191197 (2d Cir. Mar. 14, 2003).
(2) Id. at *2.
(3) Id. at *3.
(4) Id. at *4.
(5) Id.
(6) No. 01-6254, 2003 WL 548767 (2d Cir. Feb. 27, 2003).
(7) Id. at *1.
(8) Id.
(9) Id. at *3.
(10) Id. at *4.
(11) Id. at *5.
(12) Id. at *6.
(13) Id. at *7.
(14) Id. at *8.