SAN FRANCISCO
Daily Journal
www.dailyjournal.com

FRIDAY, SEPTEMBER 19, 2014

PROFESSIONAL RESPONSIBILITY

A cautionary tale of sanctions from the Northern District

By John S. Throckmorton

Judge Edward Chen, sitting in the Northern District of California, recently gave a stern rebuke to a pair of lawyers who failed to heed his warnings about fundamental weaknesses in their client's case. The decision serves as an important reminder that attorneys may be held personally accountable if they fail to adequately research the law and apply it to their case.

In *Great Dynasty International Holdings Limited v. Li*, two attorneys represented a company called Great Dynasty that assisted Chinese entrepreneurs who wanted to list their companies in the United States. In late 2009, Great Dynasty agreed to help Haiting Li with the registration of Li's company (PBEP) on the OTC Bulletin Board, in return for which Great Dynasty and affiliated individuals obtained shares in PBEP. In 2012, PBEP abandoned its efforts to list in the U.S. and decided to voluntarily deregister its stock. Great Dynasty tried to convince Li to sign a new contract so that Great Dynasty would remain PBEP's financial consultant and would oversee the company's deregistration. Li's decision instead to cut ties with Great Dynasty led to a fallout between PBEP and Great Dynasty that gave rise to parallel lawsuits: Li sued Great Dynasty in Georgia superior court for breach of contract, and Great Dynasty sued Li and his son in the Northern District of California for securities fraud and breach of fiduciary duty.

In its lawsuit, Great Dynasty alleged that it had been misled by certain statements Li had made in early 2010, but it admitted that its acquisition of PBEP shares predated those statements. Li filed a motion to dismiss that challenged causation with regard to Great Dynasty's securities fraud claims. At the hearing on the motion, Chen expressed puzzlement about the causal connection between Li's alleged misrepresentations and any loss Great Dynasty might have suffered since Great Dynasty had not traded in reliance on Li's statements. He granted the motion to dismiss but gave Great Dynasty leave to amend, noting that if it wished to pursue its securities fraud claims, Great Dynasty would need to "allege facts showing the chain-of-causation theory underlying the alleged loss, including circumstances and timing surrounding the purchase of the equity at issue."

Great Dynasty then filed a first amended complaint alleging it had "acquired or continued to hold" PBEP's shares in reliance on Li's misstatements in 2010. Chen granted Li's second motion to dismiss in part because Great Dynasty had ignored his specific instructions about the facts needed to support a nonfrivolous case: Under well-established Supreme Court precedent, a private action for securities fraud is viable only if the plaintiff purchased or sold securities in reliance on the defendant's misrepresentation. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Binder v. Gillespie*, 184 F.3d 1059 (9th Cir. 1999) ("conduct actionable under Rule 10b-5 must occur before the investor purchases securities"). Because Great Dynasty had acquired its shares before Li's alleged misstatements, it could not show such reliance. Chen again gave Great Dynasty leave to amend its complaint because one shareholder who had assigned his rights to Great Dynasty may have purchased shares in 2010 in reliance on Li's alleged misrepresentations. However, Great Dynasty, seeing the writing on the wall, elected instead to voluntarily dismiss the case.

Li then filed a motion under the Private Securities Litigation Reform Act (PSLRA) of 1995 for a mandatory inquiry as to whether Great Dynasty's filings complied with Federal Rule of Civil Procedure, Rule 11, which provides for sanctions against attorneys who bring frivolous claims. Under the PSLRA, a court is required "upon final adjudication" of a matter to make written findings as to whether the parties complied with Rule 11 in each of their filings, and to sanction attorneys for any violation of Rule 11. See 15 U.S.C. Sections 77z-1(c) and 78u-4 (c). Chen denied the request because the voluntary dismissal of the case was not a "final adjudication." He also found that sanctions could not be imposed under Rule 11 for procedural reasons.

However, acting under the court's inherent authority, Chen imposed sanctions on the attorneys because he found their assertion of claims on behalf of Great Dynasty to be both "reckless" and "frivolous." See *Fink v. Gomez*, 239 F.3d 989 (9th Cir. 2001); *Estrada v. Speno & Cohen*, 244 F.3d 1050 (9th Cir. 2001) (federal courts have the inherent authority to impose sanctions for bad faith conduct during litigation, or for willfully ignoring a court order). The attorneys knew their client could not have relied on Li's statements, and a reasonable and competent inquiry into the law would have demonstrated the holes in their theory of standing and causation. Although only one attorney had "signed" Great Dynasty's pleadings when they were filed electronically, the names of both attorneys appeared on the caption page and on the signature line of those papers, so Chen held that both attorneys should be sanctioned. He then awarded sanctions against the attorneys for the attorney fees and costs Li had incurred to defend against the securities fraud claims raised in the amended complaint, in an amount to be determined later. The parties subsequently settled the matter for an undisclosed sum.

Lawyers sometimes must contend with an emotional or insistent client who asks them to pursue a claim that lacks foundation in law or fact. In this case, Chen made it clear that the attorneys should have played a gatekeeping role, identifying the gaps, improbabilities and weak links in their client's case and counseling the client to drop claims that had no chance of prevailing. The burden was squarely placed on the lawyers to ensure both that the law supported the legal arguments they raised and that there was evidence to substantiate the factual contentions they presented: "Unlike counsel, the Court does not expect [the client] to be informed of the law in order to determine whether the claims were legally frivolous."

The result in *Great Dynasty* is a reminder that attorneys are ultimately responsible for the claims they make and the arguments they raise in court, and may be held personally accountable if a judge is persuaded that they have not met their professional obligations.

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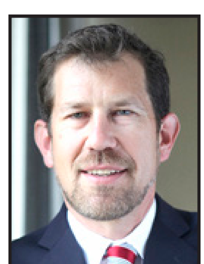

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