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### **Securities Law Update - August 2, 2007**

#### **Rule 11 – Supervise Your Partners – Read the Rule 11 Letter**

Not satisfied with its initial success in 2003 obtaining summary judgment as well as a Rule 11 ruling against Milberg Weiss Bershad & Schulman LLP, Wachovia Securities appealed to the Fourth Circuit Court of Appeals, arguing that Rule 11 sanctions should have been imposed. The trial court ruled in 2003 that Rule 11 violations occurred, but because the violations were *de minimis*, sanctions were not imposed. After remand from the Fourth Circuit, on July 20, 2007, the trial court held that sanctions were required against the firm and two of its partners. Lessons to be learned from this case include: (1) if you receive a Rule 11 letter from opposing counsel, read it, investigate it, don't ignore it; and (2) diligently supervise your partners, as well as your associates. Opinion provided below.

#### **Merrill Lynch Hoisted By Own Petard**

Merrill Lynch Trust Company ("ML Trust") managed the trust assets of a 74 year old woman and her even older, ailing husband. ML Trust's efforts allegedly lead to a loss of 50% of the couple's assets. During 1999 and 2000, ML Trust placed 90% of the couple's assets into equities. After the couple sued ML's broker dealer affiliate in arbitration, ML Trust brought a judicial action seeking a determination that ML Trust did not do anything wrong, and that ML Trust was entitled to a full release before resigning from its position as Trustee. Notably, ML Trust used trust assets to pay its own attorneys fees. ML Trust's former customers counterclaimed. In a July 11 Order, set forth below, the Court denied the majority of ML Trust's Motion. ML Trust appears to have failed with its statute of limitations defense primarily as a result of its own decision to place its conduct at issue by seeking a determination that it did nothing wrong. Simply put, ML Trust was hoisted by its own petard!

#### **Morgan Stanley Fined \$6.1 Million**

On August 2, 2007, FINRA, the NASD's successor regulatory arm, announced \$6.1 million dollars in fines against Morgan Stanley for excessive mark-ups of Lumbermen Mutual Casualty Co. bonds. Morgan Stanley marked up bonds between 6.19% and 16.18%. This

fine appears to be nothing more than a wrist slap. How many of the clients who paid between \$98.50 and \$103.00 would ever have bought these bonds had they known the bonds' true value?

### **The 2007 Subprime Debacle**

So how did two Bear Stearns hedge funds completely collapse in 2007 when the Dow seems to be hitting new highs every week? Although we have not yet had an opportunity to analyze the "guts" of the Bear Stearns hedge funds that have been in the news in recent weeks, a useful introduction to the topic is contained in Dr. Craig McCann's paper, A CMO Primer, *The Law of Conservation of Structured Securities Risk*. This piece provides an informative historical perspective on the development of different types of collateralized mortgage products. Dr. McCann's paper can be found on his website, [www.slcg.com](http://www.slcg.com).

### **Future Updates**

I sincerely hope that you are enjoying these securities law updates. I will continue to release them, but on a monthly basis. My plan is to send them out on the 1<sup>st</sup> of each month, provided that the content is worthy.

**PATRICK V. MORRIS, Individually and on Behalf of All Others  
Similarly Situated, Plaintiff, v. WACHOVIA SECURITIES, INC.,  
Defendant.**

**Civil Action No.: 3:02cv797**

**UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF  
VIRGINIA, RICHMOND DIVISION**

**2007 U.S. Dist. LEXIS 52675**

**July 20, 2007, Decided  
July 20, 2007, Filed**

**CORE TERMS:** law firm, stock loans, lead counsel, admonition, exceptional circumstances, sanctioned, summary judgment, presenter, offending, deposition, class action, summary judgment, record reflect, partner, day-to-day, submitting, assigned, opposing, de minimis, reasonableness, liaison, suspend, signing, senior, assess, discovery, senior partner, issue sanctions, legal issues, non-delegable

**COUNSEL:** For Patrick V. Morris Individually and on Behalf of All Others Similarly Situated, Plaintiff: Alain Leibman, LEAD ATTORNEY, Stern & Kilcullen, Roseland, NJ; Craig Crandall Reilly, LEAD ATTORNEY, Richard McGettigan Reilly & West PC, Alexandria, VA; Mark J. Krudys, LEAD ATTORNEY, Mark J Krudys PLC, Richmond, VA; Steven G. Schulman, LEAD ATTORNEY, Daniel

Reuben Altman, Lawrence D. McCabe, Peter Safirstein, Milberg Weiss Bershad & Schulman LLP, New York, NY.

For Wachovia Securities, Inc., Defendant: James Alwin Murphy, LEAD ATTORNEY, Cameron Scott Matheson, Harris Lee Kay, LeClair Ryan PC, Richmond, VA.

For Steven G. Schulman, Interested Party: Craig Crandall Reilly, LEAD ATTORNEY, Richard McGettigan Reilly & West PC, Alexandria, VA; Alain Leibman, Stern & Kilcullen, Roseland, NJ.

For Milberg Weiss & Bershad LLP, Interested Party: Susan Dudley Klaff, LEAD ATTORNEY, Aitan Dror Goelman, Amy Elizabeth Brown Kapp, James Amazaki McLaughlin, Zuckerman Spaeder LLP, Washington, DC.

For Mark J. Krudy, Interested Party: Mark J. Krudys, LEAD ATTORNEY, Mark J Krudys PLC, Richmond, VA.

For Wachovia Securities, Inc., Counter Claimant: James Alwin Murphy, LEAD ATTORNEY, Cameron Scott Matheson, Harris Lee Kay, LeClair Ryan PC, Richmond, VA.

For Patrick V. Morris, Counter Defendant: Alain Leibman, LEAD ATTORNEY, Stern & Kilcullen, Roseland, NJ; Mark J. Krudys, LEAD ATTORNEY, Mark J Krudys PLC, Richmond, VA; Steven G. Schulman, LEAD ATTORNEY, Daniel Reuben Altman, Peter Safirstein, Milberg Weiss Bershad & Schulman LLP, New York, NY.

**JUDGES:** Robert E. Payne, Senior United States District Judge.

**OPINION BY:** Robert E. Payne

## **OPINION**

### **MEMORANDUM OPINION**

This matter is before the Court on remand from the Court of Appeals, which affirmed the decision in *Morris v. Wachovia Securities, Inc.*, 277 F. Supp. 2d 622 (E.D. Va. 2003) but instructed this Court to impose the sanction of admonition on the lawyers responsible for violations of Fed. R. Civ. P. 11 that were found in the affirmed decision. Pursuant to that instruction, the Court considers whether it is appropriate to sanction the following persons for Rule 11 violations: Mark J. Krudys, Peter Safirstein, Steven G. Schulman, and the law firm Milberg Weiss LLP ("Milberg").<sup>1</sup>

<sup>1</sup> During the pendency of this litigation, this law firm has been called variously, "Milberg Weiss Bershad Hynes & Lerach LLP," "Milberg Weiss Bershad & Schulman LLP," "Milberg Weiss & Bershad LLP," and "Milberg Weiss LLP" -- its name at the writing of this decision.

## **I. BACKGROUND**

### **A. Procedural Background**

Patrick V. Morris filed a class action complaint against Wachovia Securities, Inc. ("Wachovia") for violations of securities laws. At the outset of the case, and on motion of the lawyers and Milberg, Steven G. Schulman, then a senior partner at Milberg, was appointed as lead counsel.

After extensive discovery and several motions, the Court issued summary judgment in favor of Wachovia, and closed the case.

Wachovia then moved for Rule 11 sanctions against Plaintiff's counsel. The Court found that Plaintiff's counsel had committed three Rule 11 violations, but concluded that the violations were "*de minimis*," and declined to issue sanctions. Wachovia appealed, and the Fourth Circuit held that the Private Securities Litigation Reform Act ("PSLRA") obliges the district court to issue sanctions for the violations. *Morris v. Wachovia Securities, Inc.*, 448 F.3d 268, 285 (4th Cir. 2006). The Court of Appeals recognized the *de minimis* nature of the violation, but nonetheless remanded the case with instructions to "enter an order naming and admonishing the lawyers responsible for the identified Rule 11(b) violations." *Id.* at 286.

On remand, Mark J. Krudys and Peter Safirstein, two of Morris's attorneys, have accepted responsibility for the Rule 11 violations. Wachovia contends that Schulman and Milberg should be sanctioned as well. Schulman and Milberg oppose imposition of sanctions on them.

## **B. Factual Background**

Morris filed this action in November 2002, alleging violations of the federal securities laws in connection with an investment account Morris had with Wachovia under one of Wachovia's investment plans, called the "Masters Program." Morris was represented originally by Krudys and Matthew B. Mooney, both members of the Virginia Bar. Mooney and Krudys prepared and filed the Class Action Complaint ("Complaint"). Declaration of Mark J. Krudys. See Docket No. 168. The Complaint alleged, *inter alia*, that Wachovia used the Masters Program to earn undisclosed revenue by using Morris's assets to make "stock loans." Docket No. 1 at 9.

After filing the Complaint, Krudys obtained assistance from Milberg, a well-known firm based in New York that specialized in representing plaintiffs in class action securities law cases. Transcript of the December 11, 2006 Testimony of Steven G. Schulman (hereinafter "Tr.") at 13-14. On January 29, 2003, on Morris's motion, the Court appointed Morris as lead plaintiff, Schulman as lead counsel, and Krudys as liaison counsel. Docket No. 11.

According to Schulman, upon his appointment to the lead counsel position, Milberg created a litigation "team" to prosecute the case. This team, according to Schulman, was constituted in the manner that was typical of the way in which Milberg handled complex class action cases.<sup>2</sup> First, Milberg assigned a senior partner as the general supervising senior partner. Tr. at 18, 24. The supervising attorney, according to Schulman, is charged with "overall strategic responsibilities." *Id.* at 4. Schulman's testimony and the record reflect that, in this capacity, Schulman took on two general duties. First, he allocated Milberg's resources among the *Morris* action and other Milberg cases. See, e.g., Tr. at 18-19, 21, 33; Wachovia Exhibit for the Dec. 11, 2006 Hearing (hereinafter "Wachovia Ex.") 16; Schulman's Exhibits for the December 11, 2006 Hearing (hereinafter "Schulman Exs.") 13B, 14B, 14D, 14F. Second, Schulman kept up with the progress of this action.

<sup>2</sup> Schulman testified that, whether an attorney at Milberg, or Milberg itself, is appointed as lead counsel, the case is managed in the same fashion, with overall managing counsel, senior litigators, associates, and liaison counsel playing roughly similar roles. Tr. at 18-19.

The record confirms that Safirstein emailed Schulman with updates of events in the case, see Schulman Exs. 13A-E, 13I, 14A, 14E, 14G, 14H, 14J, 14N, and sent Schulman pleadings and briefs that Milberg filed; Safirstein Declaration, Schulman Ex. 10 at 2; that Schulman read and commented on some motions and drafts, but not others; see Schulman Exs. 14N, 16; Tr. at 85; and that Schulman conferred with Safirstein about the strategy that Milberg was employing in this action. See, e.g., Schulman Ex. 10 at 2-3. Schulman and Safirstein agree that, although Schulman

consulted with Safirstein to decide how Milberg might approach legal issues in the case, and reviewed some papers submitted to the Court, Schulman relied on Safirstein to conduct factual investigations and research specific legal questions in the case, and to draft the motions and memoranda that were filed.

Schulman explained that, as was its custom in complex cases, Milberg also assigned a senior litigator to "run the case day-to-day." Schulman described this role as "the most visible, active and day-to-day . . . partner handling this case through the fighting, the arguing, the briefing, the interaction with co-counsel and defense counsel and the court . . . ." Tr. at 24. Schulman assigned this role to Safirstein, a lawyer at Milberg who recently had become partner at the firm. Indeed, Krudys initially asked Safirstein to take the case, and Safirstein had asked to be placed in charge of it. *Id.*; Schulman Ex. 6. Schulman testified that he had a great deal of confidence in Safirstein's abilities to handle the litigation because Safirstein was an experienced lawyer who had worked in securities litigation for more than a decade, and because Schulman was aware of Safirstein's work in a previous Milberg case and had been satisfied with the results. Tr. at 10-11. Schulman testified that, throughout the litigation, he trusted Safirstein to manage the attorneys who were assigned to the case, *id.* at 24, to conduct investigations of the facts and law particular to the case, to write the motions and memoranda in the case, and to manage the argument of those motions in court. *Id.* at 18, 24-25, 29-30; Schulman Ex. 10. Schulman's testimony and the record reflect that Schulman also reviewed some of these motions, and consulted with Safirstein about how to address particular legal issues.

Schulman testified that Milberg typically works with liaison counsel. Schulman testified that the *Morris* litigation was somewhat unusual, because the liaison counsel, Krudys, had initiated the case and referred it to Milberg, see Tr. at 24-25; Schulman Memorandum (Docket No. 188) at 5, and because Krudys was involved in drafting legal documents and making arguments to the Court, roles not usually filled by local counsel associated with Milberg. Tr. at 24-25. Schulman testified that he never interacted directly with Krudys during the litigation, but rather delegated that responsibility to Safirstein. *Id.* at 25.

Finally, Milberg also assigned less experienced attorneys and other staff to the case, as necessary. *Id.* at 21. The record reflects that Schulman was involved in coordinating the staffing needs in the *Morris* litigation with Milberg's other litigation matters. *Id.* at 18-19, 21; Wachovia Ex. 16; Schulman Exs. 13B, 14B, 14D, 14F. Schulman does not appear to have interacted directly with these other attorneys and staff members, but rather relied on Safirstein to manage their work. Tr. at 29-30.

On February 7, 2003, Plaintiff, with Milberg by then at the helm, filed an Amended Class Action Complaint ("Amended Complaint"). Docket No. 16. The Amended Complaint re-alleged the "stock loan" claim that first appeared in the Complaint filed by Krudys. Krudys signed the Amended Complaint, and Schulman and Safirstein were listed in typeface as counsel of record (as they were on subsequent pleadings and briefs). In his Declaration, Safirstein states that Schulman "relied on me to conduct the necessary factual investigation and legal analysis" of the allegations in the Amended Complaint. Schulman Ex. 10.

On February 28, 2003, Wachovia moved to dismiss the Amended Complaint. Docket No. 19. Five days later, counsel for Wachovia sent a letter addressed to Schulman as lead counsel. Wachovia Ex. 8. In the letter, which served as a Rule 11 notice, Wachovia's counsel stated that the Amended Complaint contained numerous inaccuracies. Among these, the "stock loan" allegation was said to be false because "no stocks in the Masters Program are loaned as alleged by Mr. Morris." *Id.* at 2. Schulman testified that he was not sure whether he saw or read the Rule 11 Letter at the time Milberg received it, Tr. at 99-100, and speculated that Milberg's mailing system might have forwarded the letter directly to Safirstein because Safirstein was listed as the attorney in

charge of the case's day-to-day conduct. *Id.* at 108-09. Milberg did not immediately reply to the Rule 11 Letter. Instead, on March 17, it filed an opposition to the motion to dismiss, which continued to press the "stock loan" allegation. Docket No. 22. Schulman's time log reflects that he spent one hour reviewing the opposition brief on March 16. Wachovia Ex. 9.

On March 21, 2003, Milberg responded to the Rule 11 Letter. Wachovia Ex. 12. Schulman's time records reflect that he spent one hour reviewing that response. *Id.* Ex. 11. According to Schulman, the letter disagreed with Wachovia's position regarding the "stock loan" claim. Milberg's response, however, did not specifically mention the "stock loan" allegation. Instead, it incorporated the positions Plaintiff had taken in the Opposition to Wachovia's Motion to Dismiss filed four days earlier. Tr. at 103-05.<sup>3</sup>

3 The Response letter reads, "As you have seen from Plaintiff's [Opposition to Wachovia's Motion to Dismiss], we do not agree with your argument that 'numerous of the allegations in the Amended Complaint are not true.'" Wachovia Ex. 12.

On Wachovia's motion, the Court dismissed the Amended Complaint. The dismissal was without prejudice to the filing of a Second Amended Class Action Complaint ("Second Amended Complaint"). On May 9, 2003, Plaintiff filed a Second Amended Complaint. Docket No. 37. In the Second Amended Complaint, the "stock loan" allegation was removed.<sup>4</sup> Wachovia moved to dismiss the Second Amended Complaint. Docket No. 38. On August 12, 2003, the Court dismissed some claims in the Second Amended Complaint and declined to dismiss others. Docket No. 48.

4 Schulman's time records show that on May 1, he billed one-half hour to "Wachovia--att[ention] to status." Wachovia Ex. 14 at the December 11 hearing, Schulman explained, "[attention to status] means that I'm looking at what's happening in the case that day and bringing myself up to date." Tr. at 122.

Thereafter, extensive discovery ensued. On May 17, 2004, Wachovia moved for summary judgment. Docket No. 105. During discovery, Plaintiff's counsel had taken depositions of Burt White, a Wachovia officer, and Charles W. Baldiswieler, a money manager for the Masters Program. In its memorandum opposing Wachovia's motion for summary judgment, Docket Nos. 113 and 116, Plaintiff's brief mischaracterized Baldiswieler's and White's testimony. A week before Milberg filed its memorandum in opposition, Safirstein told Schulman in an e-mail, "I know this case cold." Schulman Ex. 14F.

Schulman testified that he did not remember whether he had read the memorandum opposing Wachovia's motion for summary judgment, Tr. at 128-29, and that he was unfamiliar with Baldiswieler's and White's testimony. When asked whether he took any steps to ensure that the memorandum opposing summary judgment was "grounded in fact and law," Schulman testified that the step he took was to "satisfy [him]self that Mr. Safirstein was in a position to properly respond to the motion." Tr. at 127. Safirstein, in his Declaration, states that "Schulman reviewed, but did not prepare the memorandum in opposition [to the Motion for Summary Judgment]. He . . . relied upon me to have properly characterized the deposition testimony in any filing with the Court." Schulman Ex. 10. In argument at the summary judgment hearing, Plaintiff's counsel again mischaracterized Baldiswieler's and White's testimony. Schulman did not attend the summary judgment hearing.

The Court granted Wachovia summary judgment on all of Morris's remaining claims on August 2, 2004, Docket No. 130, and closed the case. Wachovia then moved for Rule 11 sanctions.

Milberg's records reflect that Schulman billed a total of 10.75 hours on the *Morris* matter. Schulman Ex. 7. At the December 11 hearing, Schulman testified that he had spent around twenty

to thirty additional, unbilled hours on the case, consisting of email correspondence, "impromptu discussions," and the like. Tr. at 34-35. Milberg's billing records reflect that the firm devoted a total of around 3,100 attorney-hours and around 800 staff-hours to the case. Wachovia Ex. 22.

## II. DISCUSSION

### A. Sanctions Against Safirstein And Krudys

In the June 21, 2006 telephone conference, Safirstein and Krudys accepted responsibility for the violations. This comports with the record, which reflects that Safirstein and Krudys created the offending pleadings together, and that they were both intimately familiar with the details of the case. The Court therefore finds that Safirstein and Krudys have responsibility for the three Rule 11 violations, and, as instructed by the Court of Appeals, they will be admonished in a forthcoming Order.

### B. Sanctions Against The Law Firm

Milberg argues that, even though at least one of its attorneys has violated Rule 11, it should not be sanctioned itself because "exceptional circumstances" attend this case. Milberg's arguments supporting this position are unpersuasive.

Rule 11(c)(1)(A) provides that "[a]bsent exceptional circumstances, a law firm shall be held jointly responsible for violations committed by its partners, associates, and employees." This provision was added as part of the 1993 Amendments to Rule 11. The Advisory Committee Note to the 1993 Amendments states that this provision was added because "it is appropriate that the law firm ordinarily be viewed as jointly responsible [for its attorney's Rule 11 violations] under established principles of agency." Rule 11 1993 Amendments Advisory Committee Note. One commentator cited by Wachovia explains that, under the 1993 Amendments, "[p]erhaps a firm could get off the hook by raising the defense that a rogue lawyer altered a firm-approved pleading before submitting it or disobediently filed a pleading his superiors had rejected as frivolous," but "if a firm's liability for its lawyers' Rule 11 violations is not absolute, it is very nearly so." Ted Schneyer, *A Tale of Four Systems: Reflections on How Law Influences the "Ethical Infrastructure" of Law Firms*, 39 S. Tex. L. Rev. 245, 259 (1998).

Filing pleadings in a case prosecuted by his firm is, of course, at the center of a lawyer's duties, and places his law firm squarely in liability as *respondeat superior* under established principles of agency. Nevertheless, Milberg identifies three "exceptional circumstances" that it claims should excuse it from sanctions.

First, Milberg argues that the Fourth Circuit's remand was a narrow one that directed the Court to sanction only the *lawyers* in the case. Milberg notes that the Fourth Circuit directed the Court to "issue a written order admonishing by name the *individual lawyers responsible* for the Rule 11(b) violations that the district court identified," *Morris*, 448 F.3d at 285 (emphasis supplied by Milberg), and draws from this that the Court of Appeals, *expressio unius est exclusio alterius*, meant for the Court to sanction *only* lawyers, and not the firm. Milberg misconstrues the remand instructions.

This Court originally found three Rule 11 violations, but declined to issue sanctions because it concluded that the violations were *de minimis*. Because the Court issued no sanctions to lawyers, it never addressed Milberg's *respondeat superior* liability. The question presented on appeal was "whether the district court, within its discretion, appropriately sanctioned Morris's lawyers under Rule 11." *Id.* at 284. The Court of Appeals concluded that the PSLRA required some sanction beyond a finding of violation, *id.* at 285, and issued a remand instructing this Court to "issue a one-sentence admonition" to Morris's lawyers for the violation. *Id.* The Court of Appeals concluded that

such a "narrow remand" was appropriate because the "implication" of this Court's violation finding was that "had [this Court] understood that the [PSLRA] required it to impose a sanction, it would have imposed the non-monetary sanction that flows most naturally from its finding--namely, admonition." *Id.*

The Court of Appeals remand was "narrow" in the sense that it narrowed the *type* of sanction this Court was to issue. There is nothing in the reasoning of the Court of Appeals' decision, however, suggesting that it otherwise meant to create restrictions on what types of responsible entities this Court should sanction. Indeed, the Court of Appeals' reference only to "lawyers" is consistent with its observation that "[t]he district court is familiar with the proceedings and filings in this case and is therefore better suited than we are to identify those lawyers." *Morris*, 448 F.3d 285.

The Court of Appeals is not required to specify each possible outcome of a Rule 11 inquiry for the Rule to be in effect. To read an exception for the law firm would contradict the Court of Appeals' observation that, under the PSLRA, sanctions must be issued "in accordance with Rule 11." *Morris*, 448 F.3d at 284. Rule 11, in turn, directs courts to hold law firms accountable for their lawyers' actions by looking to principles of agency. The "narrowness" of the Court of Appeals' remand, therefore, is not an "exceptional circumstance" excepting Milberg from sanctions.

Second, Milberg argues that, because this Court found these violations to be *de minimis*, issuing a sanction against the firm itself is inappropriate. Milberg cites decisions in which courts declined to find "exceptional circumstances" excusing law firms, where the violations were egregious. Milberg extrapolates from these decisions that, where the violations are less severe, "exceptional circumstances" exist that excuse law firms from Rule 11 liability.

This argument is unpersuasive. The 1993 Advisory Committee understood a law firm's liability for its attorney's conduct to operate on "established principles of agency." Rule 11 1993 Amendments Advisory Committee note. Filing briefs in the prosecution of a litigation sits in the heartland of the agency relationship between a litigator and his law firm. Milberg does not identify a principle that would suspend the agency when a lawyer's transgression is less severe. The fact that other courts have not found "exceptional circumstances" when confronted with severe violations does not lead to, or even hint at, a rule of interpretation that would find an "exceptional circumstance" sufficient to suspend the "established principles of agency" when the violation is minor. To find such an exception would go against the stated purpose for the addition of this provision to the Rule: holding law firms responsible for their lawyers' Rule 11 violations under established principles of agency.

Finally, Milberg argues that there are "exceptional circumstances" here because the Court is only contemplating a written admonition rather than any form of monetary sanctions. It reasons that, while individual lawyers might be embarrassed and thus chastened by a Rule 11 admonition, an admonition alone "cannot generate the same shame and introspection in an institution."

This argument is also unpersuasive. Milberg does not explain how a simple admonition would suspend "established principles of agency." In any event, aside from whatever introspection Rule 11 sanctions might inspire, Rule 11's "central goal" is deterrence. *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 393 (1990). The Rule 11 admonition required here will be part of the public record. Rule 11 admonitions on the public record deter because they publicly rebuke the lawyer. Law firms, no less than lawyers, have reputations to maintain, and, while the threat of public admonition is perhaps not the most serious of sanctions, it is a deterrent nonetheless, to lawyers and law firms alike. Indeed, while Milberg suggests that it will not be chastised by a public rebuke, it ought to be, and the Court is quite taken aback by the contrary suggestion. The absence of monetary penalties, therefore, does not make for an "exceptional circumstance" that might suspend Milberg's joint

liability under Rule 11(c)(1)(A). Perhaps the admonition will prompt Milberg, as well as other firms, to provide more training and supervision to avoid situations such as this one.

In this case, at least one Milberg lawyer committed three Rule 11 violations while acting as an agent, and within the scope of his agency, for Milberg. Pursuant to Rule 11(c)(1)(A), it is therefore appropriate to hold Milberg jointly responsible for the three Rule 11 violations. The Court will admonish the firm in a forthcoming Order.

### **C. Sanctions Against Schulman**

Wachovia argues that, even though Schulman did not sign any of the pleadings, he committed, and also is responsible for the commission of, the three Rule 11 violations. Wachovia is only partially correct.

#### **1. Liability As A "Presenting" Attorney**

Wachovia first argues that Schulman is liable as a "presenter" under Rule 11(b). This argument is incorrect.

Rule 11(b) provides that: "[b]y presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party" certifies that its legal arguments and factual assertions have merit. Fed. R. Civ. P. 11(b). Wachovia acknowledges that Schulman never actually delivered or mailed the offending papers to the Court. Nonetheless, Wachovia argues that, because Schulman authorized the filing of the offending papers, he should be considered to have "filed" and "submitted" them under "established principles of agency." See Reply Memorandum of Wachovia Securities Regarding Steven G. Schulman's Responsibility for Rule 11 Violations (Docket No. 191) at 8.<sup>5</sup> Therefore, argues Wachovia, Schulman should be considered a "presenter" for purposes of Rule 11(b). This argument misunderstands the import of the 1993 amendments to Rule 11. While Rule 11(c) may create agency liability for Rule 11 violations, Rule 11(b) does not. Schulman did not personally file or submit papers. He therefore did not "present" them for purposes of Rule 11, and is not liable as a presenter under Rule 11(b).

5 Schulman never signed any of the papers, or appeared before the Court during the litigation, and Wachovia does not argue that Schulman "signed" the papers or "advocated" them.

Rule 11 was amended in 1983, and then again in 1993.<sup>6</sup> Under its 1983 version, which was in effect until 1993, the Rule required that all papers filed with the court be signed by an attorney, and that, by that signature, the signer certified that he had read the paper, and that, if the court found that the Rule had been violated, it was to "impose upon the person who signed it . . . an appropriate sanction . . . ." Fed. R. Civ. P. 11 (1983)(repealed 1993). Courts identified two problems (pertinent here) with the 1983 Rule. First, not all submissions to the courts are typically signed, and there was confusion over what submissions triggered Rule 11 liability. See *Bus. Guides, Inc. v. Chromatic Commc'ns Enter., Inc.*, 498 U.S. 533, 540 (1991) (Kennedy, J., dissenting) (questioning whether the 1983 Rule reached affidavits submitted to a court *in camera*); *Eisenberg v. University of New Mexico*, 936 F.2d 1131, 1133 (10th Cir. 1991) (relying on *Business Guides* to hold that, even though an affidavit was not "filed," it had been "submitted" to the court for Rule 11 purposes).

6 There have also been technical revisions to the Rule, which are not relevant here.

Second, in *Pavelic & LeFloure v. Marvel Entertainment Group*, 493 U.S. 456 (1989), the Supreme Court held that Rule 11 did not create vicarious liability, and that only the attorney who actually signed the offending paper could be sanctioned. In *Pavelic*, a partner in the two-person law firm had signed court papers, on behalf of the firm, that violated Rule 11. The Court held that the partner's law firm could not be sanctioned under vicarious liability because "[w]e are . . . dealing here . . . with a Rule that strikingly departs from normal common-law assumptions such as that of delegability." 493 U.S. at 459. The Court explained that, "[w]here the text establishes a duty that cannot be delegated, one may reasonably expect it to authorize punishment only of the party upon whom the duty is placed." *Id.*

The 1993 amendments to Rule 11(b) replaced "signing" accountability with "presenting" accountability, and specified that a person presents a paper by signing, filing, submitting it, or by later advocating its contents. See Gregory P. Joseph, *Sanctions: The Federal Law of Litigation Abuse*, § 5(C)(1) at 88 (3d Ed. 2000) (hereinafter "*Sanctions*") (noting that the "filing" and "submitting" language was designed to resolve problems that "had largely been finessed," under the 1983 Rule, and citing *Eisenberg* and *Business Guides* as examples). The Advisory Committee's Note explains, however, that the presenter "has a nondelegable responsibility to the court, and in most cases is the person to be sanctioned for a violation." Rule 11 1993 Amendment Advisory Committee's note. The Supreme Court's observation in *Pavelic* about the 1983 version of Rule 11 certainly applies to Rule 11(b): "Where the text establishes a duty that cannot be delegated, one may reasonably expect it to authorize punishment only of the party upon whom that duty is placed." 493 U.S. at 459. Here, Rule 11(b) placed a non-delegable duty on those attorneys who filed and submitted the offending papers or who argued them before the Court. This non-delegable duty does not extend to an attorney who authorized the filing or submission, but who did not file the papers himself.<sup>7</sup>

7 Wachovia argues that this understanding of "presenter" would unfairly expose an attorney who simply dropped of a paper with the court as a favor to another attorney to non-delegable presenter liability. This is not necessarily so. The Advisory Committee's Note provides that a responsible attorney may be sanctioned "in addition to, or . . . instead of the person actually making the presentation to the court." Rule 11 1993 Amendments Advisory Committee Note.

Thus, Rule 11(b) places liability only on a lawyer who "signs," "files," or "submits" a pleading or who later "advocates" its content, not on anyone else. Wachovia does not contend that Schulman signed, filed, or submitted an offending paper or later argued its contents. Thus, Schulman is not sanctionable under Rule 11(b).

Of course, that is not the end of the inquiry, because Rule 11(c) permits sanction of attorneys other than presenters who are "responsible" for the violation. This, of course, was the second pertinent change of the 1993 amendments, and it was designed to address the non-vicarious nature of Rule 11 liability identified in *Pavelic*. Rule 11(c) permits a court to sanction "the attorneys, law firms, or parties that have violated [Rule 11](b) or *are responsible* for the violation." Fed. R. Civ. P. 11(c) (emphasis added). The Advisory Committee explained that this provision allowed courts to sanction attorneys "for *their part in causing* the violation. . . . in addition to . . . the person actually making the presentation to the court." Rule 11 1993 Amendments Advisory Committee Note (emphasis added).

As Joseph notes in *Sanctions*, Rule 11(c) is designed to address precisely these circumstances: "If a person expressly *authorizes* the signing, filing, submitting or later advocating of the offending paper, that person shares responsibility with the signer, filer, submitter, or advocate [under Rule 11(c)]." *Sanctions*, § 5(E)(1) at 110 (emphasis added). The Court need not

go through "mental gymnastics," as pre-1993 courts sometimes felt compelled to do, see *Sanctions*, § 5(E)(1) at 109, in order hold Schulman to account under Rule 11.

Schulman authorized the filing of the papers, and therefore is exposed to liability under Rule 11(c). To that point, we now turn.

## 2. Liability As A "Responsible" Attorney

Alternatively, Wachovia argues that, even if Schulman is not found to be a presenter, he should be sanctioned because he is "responsible" for the violations within the meaning of Rule 11(c). Schulman counters that he should not be sanctioned because his reliance on others to investigate the facts and the law in the case was reasonable.

Under the 1993 Amendments, the Court may sanction "the attorneys, law firms, or parties that . . . are responsible for the [Rule 11] violation." Fed. R. Civ. P. 11(c). The Advisory Committee Note to the 1993 Amendments states that "[t]he sanction should be imposed on the . . . attorneys . . . who have violated the rule or who may be determined to be responsible for the violation."

Neither party disputes that a lead counsel may be held responsible for papers submitted by other attorneys whom he supervises in a case. Both parties also agree, implicitly, that a lead counsel should not be held liable if his reliance on the attorneys he supervised was reasonable.<sup>8</sup> Indeed, under Rule 11, an attorney may rely on other attorneys for factual assertions, if that reliance is reasonable. See, e.g., *Donaldson v. Clark*, 819 F.2d 1551, 1556 (11th cir. 1987); American Bar Association, Section of Litigation, *Standards and Guidelines for Practice under Rule 11 of the Federal Rules of Civil Procedure* (1988) (hereinafter "*Standards*") §§ (D)(11); *Sanctions* § 8 (discussing factors generally and discussing factors set forth in *Standards*).

<sup>8</sup> Schulman's theory on defense is that his reliance on Safirstein was reasonable. The case Wachovia cites for its argument that Schulman is liable held a supervising attorney responsible because his reliance on a second lawyer was unreasonable. See Memorandum of Wachovia Securities Regarding Steven G. Schulman's Responsibility for Rule 11 Violations (Docket No. 189) at 11-12 (citing *Jenkins v. Methodist Hosps. of Dallas, Inc.*, 2004 U.S. Dist LEXIS 25131, \*2, \*3, \*6, \*7 (N.D. Tex. August 18, 2004).

The Fourth Circuit has held that counsel's actions must be reviewed under an objective standard of reasonableness, rather than the attorney's subjective mental state. *In re Kunstler*, 914 F.2d 505, 518 (4th Cir. 1990). The standard for reasonableness asks whether a reasonable attorney in like circumstances would believe the actions in question to have been justified. *Cabell v. Petty*, 810 F.2d 463, 466 (4th Cir. 1987).

The parties have cited no decisions issued by the Fourth Circuit that set forth specific standards for measuring reasonable reliance on other attorneys. However, to assess the reasonableness of an attorney's inquiries generally, several other courts have looked to Joseph's *Sanctions* treatise. See, e.g., *Obifuele v. 1300, LLC*, 2006 U.S. Dist. LEXIS 60043, \*14-15 (D. Md. Aug. 23, 2006); *R.B. Ventures, Ltd. v. Shane*, 2000 U.S. Dist. LEXIS 10170, \*7 (S.D.N.Y. 2000). *Sanctions* adopts the criteria set forth by the ABA in *Standards* to assess whether one attorney's reliance on another's investigation is reasonable. The ABA's criteria in *Standards* were promulgated before the 1993 amendments, so they address the liability of a signer under the 1983 version of the Rule. Nonetheless, these criteria are useful to help assess the reasonableness of Schulman's reliance on Safirstein and the other attorneys on the *Morris* "team." The criteria include:

- (1) The complexity of the factual and legal issues in question;

- (2) The availability of alternate sources of information;
- (3) The extent to which counsel relied upon other counsel for the facts underlying the paper;
- (4) The extent to which the attorney was on notice that further inquiry might be appropriate;
- (5) The respective experience of relying counsel and of counsel on whom reliance is placed;
- (6) The history, duration and nature of the relationship between counsel;
- (7) The respective roles of counsel in the litigation (e.g., local counsel, lead counsel, forwarding counsel).

*Standards* §§ D(5), (D)(11) (referenced in *Sanctions* § 8(A)(8)). It is also axiomatic that courts should avoid judging the conduct of counsel with "the wisdom of hindsight" simply because a violation occurred. Rule 11 1983 Amendment Advisory Committee's note.

With the foregoing in mind, it is necessary now to assess Schulman's amenability to sanctions under Rule 11(c).

#### **a. The Baldiswieler and White Testimony**

In the Plaintiff's memorandum in opposition to Wachovia's motion for summary judgment, and again at the summary judgment hearing, Plaintiff's counsel mischaracterized the testimony of two witnesses, Messrs. Baldiswieler and White. Schulman testified that, under the allocation of responsibilities in the case, he had entrusted Safirstein correctly to characterize testimony that was cited in the briefs, Tr. at 127, and, in an e-mail that was sent before the summary judgment process, Safirstein assured Schulman that he was comfortable with the facts in the case. Schulman Ex. 14F.

The analysis begins with the proposition that this was a complex factual and legal case and that there was extensive discovery. The principal sources of information available to Schulman when he authorized the filing of the opposition to the motion for summary judgment were the contents of the brief that he reviewed, the contents of the deposition testimony and the assurance of Safirstein. Safirstein was in charge of the litigation day-to-day, and considering the roles of counsel in the litigation within the firm, it was reasonable for Schulman to rely upon Safirstein to know these details. And, indeed, the violations involving the Baldiswieler and White testimony were over somewhat minute details of an otherwise lengthy deposition. While Schulman could have read the deposition, it is not reasonable, under the circumstances, to have expected that he read every deposition citation referred to in a brief, so long as he was assured by Safirstein that the facts in the brief were correctly recited. That is particularly true where, as here, Schulman was not on notice that further inquiry respecting the cited testimony would be appropriate.

In sum, it is reasonable for complex litigation to be organized in a way that allows counsel to provide the best professional service at the most reasonable expense. The structure adopted by Milberg, with Schulman at the helm and Safirstein in day-to-day charge of the several other lawyers and staff who worked on the case, was a reasonable way in which to handle the representation in this case. Safirstein had a history of experience in securities litigation and had earned the confidence of the law firm by recently having been made a partner in it. It was reasonable of Schulman, given his knowledge of Safirstein and his background, to rely on

Safirstein correctly to cite, or to assure the correct citation of, deposition testimony in the opposition brief.

There is no indication that Schulman participated in the formulation of the argument at summary judgment. However, Schulman reasonably could have been expected to know that, unless told otherwise, the contentions pressed in the brief would be asserted at the summary judgment argument. But, it was reasonable of Schulman to expect that Safirstein would check the references in the briefs if they had been criticized by the opposing side's briefs and to make adjustments in the argument accordingly.

On balance, and considering the record as a whole, it was reasonable of Schulman to rely on Safirstein to verify the accuracy of the Baldiswieler and White testimony before either asserting it in a brief or relying on it at argument. Therefore, Schulman cannot be held accountable as a person responsible for the violations involving the Baldiswieler and White testimony.<sup>9</sup>

9 All seven of the *Standards*/ABA factors support this conclusion.

#### **b. The "Stock Loan" Claim**

The third violation of Rule 11 involves the allegation in the Amended Complaint respecting the so-called "stock loan" claim. The Rule 11 letter sent by Wachovia's counsel on March 5, 2003 was addressed to Schulman. The Rule 11 letter asserted that the "stock loan" allegation was incorrect because "no stocks in the Masters Program are loaned as alleged by Mr. Morris." Wachovia Ex. 8, p. 2. Although Schulman does not recall receiving or reviewing the Rule 11 letter, it is reasonable to believe that the letter was delivered to him, and it is reasonable to have expected him to read a letter of this sort, if not immediately upon receipt, then certainly before authorizing the opposition brief then in preparation.

The Rule 11 letter was not lengthy and it pointed out four fundamental flaws in the Amended Complaint, one of which was the premise upon which the "stock loan" claim was based. Confronted with a charge that an allegation of the complaint is false, counsel has a responsibility to re-examine the basis upon which that assertion is made and either to abandon it or to be sure that there is a factual predicate for it before pressing further with it.

Schulman authorized the filing of the motion opposing the dismissal of the Amended Complaint in which the Plaintiff continued to press the "stock loan" claim after having been told in a Rule 11 letter that the predicate for it was false. At the time Schulman, as lead counsel, was the senior person who had overall strategic responsibility for the case. Tr. at 29. Whether to assert a claim such as the "stock loan" claim is a significant decision on a significant substantive issue. That is particularly true where, as here, counsel had been informed that the basis upon which the claim had been made was false. It was part of Schulman's responsibility to have assured that there was a factual basis for the claim.

It is the responsibility of lead counsel in a case who holds the responsibility for overall strategic decisions and overall management of the case, as did Schulman, to assure himself that the basic legal theories upon which a case is to proceed are grounded in fact and law. Here, the record shows that Schulman took no action to that end after having been informed by the Rule 11 letter that the "stock loan" claim was false. Schulman's responsibility was to ferret out and identify the basis of the "stock loan" claim, to review the factual predicate for the claim against the applicable law, and to make the decision whether that claim should be pressed at all. The record does not reflect that Schulman took any such action. Nor, contrary to arguments made by the Plaintiff's briefs, does it appear that Safirstein took any action to address the issue. Under these circumstances, Schulman cannot be heard to say that he reasonably relied upon Safirstein, for

there is nothing to show that Safirstein undertook to act in a way that would permit Schulman to have reasonably relied upon Safirstein's judgment.

Accordingly, and for the foregoing reasons, Schulman is responsible, within the meaning of Rule 11(c), for the "stock loan" claim violation. He will be appropriately admonished for that violation.

Wachovia also seeks to have Schulman held accountable for the "stock loan" violation, and for the Baldiswieler and White testimony violations, on the alternate theory that he abdicated his responsibilities as lead counsel. In fact, Schulman devoted only approximately ten billable hours to this case and, he says, that he devoted an additional twenty to thirty hours, Tr. at 34-35, that were not billed. It is doubtful that the work performed by Schulman as lead counsel was adequate to satisfy the responsibilities of lead counsel, but whether the responsibilities of lead counsel were satisfied is not the proper measure of whether sanctions should be imposed. Wachovia has cited no authority which would support such an application of Rule 11(b) or (c).

### **III. CONCLUSION**

For the reasons set forth above, the Court finds that Milberg and Messrs. Safirstein and Krudys are responsible for all three Rule 11 violations found in this case, and that Mr. Schulman is also responsible for the violation involving the assertion of the "stock loan" claim. An Order shall issue consistent with this Memorandum Opinion.

The Clerk is directed to send a copy of this Memorandum Opinion to all counsel of record.

It is so ORDERED.

Robert E. Payne

Senior United States District Judge

Richmond, Virginia

Date: July 20, 2007

**Merrill Lynch Trust Company, FSB v. Campbell, et al.**

**C.A. No. 1803-VCN**

**COURT OF CHANCERY OF DELAWARE, KENT**

**2007 Del. Ch. LEXIS 95**

**March 28, 2007, Submitted**

**July 11, 2007, Decided**

#### **NOTICE:**

THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

**COUNSEL:** [\*1] Dennis A. Meloro, Esquire, Greenberg Traurig, LLP, Wilmington, DE.

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**JUDGES:** John w. Noble, VICE CHANCELLOR.

**OPINION BY:** John w. Noble

## **OPINION**

When the settlor-beneficiary of a trust expressed her dissatisfaction of the trustee by designating a successor-trustee, yet refused to release the trustee and its affiliates, the trustee brought this action seeking judicial confirmation of its conduct. In turn, the settlor-beneficiary filed a counterclaim, subsequently amended, that alleges that the trustee employed fraud and misrepresentation to induce her to enter into the trust agreement, that the investment strategy employed by the trustee failed to meet the prevailing standard of care, and that the trustee wrongfully withdrew funds from the trust to pay the trustee's legal fees, including those incurred in an effort to enjoin an arbitration brought by the settlor-beneficiary even though the trustee was not a party in the arbitration proceeding.

### **I. BACKGROUND**

1

1 The background is drawn from the well-pleaded allegations of the Amended Counterclaim.

In 1996, Defendant-Counterclaimant Mary F.C. Campbell ("Campbell"), a resident of Delaware, then [\*2] 74 years of age with an even more elderly husband in failing health, was persuaded by representatives of subsidiaries of Merrill Lynch & Co. to establish a charitable remainder unitrust (the "Trust") with a predecessor of Plaintiff Merrill Lynch Trust Company, FSB ("Merrill Lynch Trust") as the Trustee.<sup>2</sup> She would come to regret that decision.

2 The Irrevocable Unitrust Agreement (the "Trust Agreement"), dated August 8, 1996, appears as Exhibit B to the Complaint. The initial Trustee was Merrill Lynch Trust Company of America. Merrill Lynch Trust is its successor by a merger that occurred on January 2, 2001. The

Court refers to both corporate trustees as "Merrill Lynch Trust."

Campbell's husband had managed the family's finances until his deteriorating health deprived him of the capacity to perform that function. Campbell turned to Baerbel O'Haire, a long-time advisor and broker in the Vero Beach, Florida office of Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Pierce"), the brokerage arm of Merrill Lynch & Co. and a sister entity to Merrill Lynch Trust. Pierce and Merrill Lynch Trust cross-market each other's products and Pierce provides services to Merrill Lynch Trust under a confidential [\*3] agreement.

Merrill Lynch Trust and Pierce persuaded Campbell to place the bulk of the family's holdings--primarily 10,000 highly appreciated shares of Exxon stock--in a charitable remainder unitrust through the following representations, upon which Campbell relied:

1. O'Haire represented that the Trust corpus would grow, above the 10% annual distributions to Campbell and subsequent life beneficiaries. Such a consistent earning growth, Campbell alleges, would be unattainable over any reasonably projected time span.

2. A vice president of Merrill Lynch Trust informed Campbell that she could avoid capital gains tax liability from the sale of the Exxon stock which needed to be sold in order to provide income and to allow for diversification. It is alleged that the tax advice was wrong; the capital gains liability would only be deferred until the time of distribution--not avoided.

3. Merrill Lynch Trust also touted the charitable benefits that could be achieved. It turns out that, given the structure of the Trust, less than one percent of the assets contributed, or slightly more than \$ 6,000, would qualify for a charitable deduction. That five beneficiaries were named--each projected to receive [\*4] only a little more than \$ 1,000--is further evidence of Campbell's expectations about the scope of the charitable benefits that could be achieved.

4. Campbell understood that she would have no personal control over the assets placed in the Trust portfolio, but she was promised that O'Haire, the long-time advisor in whom she had placed her trust and confidence, would continue to play an active role in the management of those assets. Indeed, O'Haire, for several years after establishment of the Trust, was identified as "your financial consultant" and as the "personal contact and relationship manager." In reality, all investment decisions were made by Merrill Lynch Trust with no apparent input from O'Haire. Moreover, Merrill Lynch Trust and Pierce would later take the position that Pierce's only involvement was "custodial" in nature.

In addition, O'Haire, as a representative of Pierce, arranged for an attorney in New York to draft the Trust instrument. The attorney never spoke with Campbell during the negotiation process; all communications, except for a limited communication after transmittal of the final draft were with O'Haire.<sup>3</sup> The attorney never attempted to negotiate and, far more [\*5] importantly, never explained to Campbell, her client, the numerous provisions in the Trust Agreement that could reasonably be viewed as adverse to Campbell's interests, including:

3 The attorney's other communication with Campbell occurred when she sent the bill for her services to Campbell.

1. Merrill Lynch Trust's unilateral ability to increase its fees;

2. No requirement that Merrill Lynch Trust seek the most cost effective brokerage service fees; instead, it could pay whatever standard fees Pierce might charge;

3. Unavailability of arbitration in the event of failures by Merrill Lynch Trust, including bad portfolio performance, although arbitration was generally the only means by which disappointed consumers of Pierce's services could seek a remedy;

4. A reduced duty of care required of Merrill Lynch Trust; and

5. Campbell's inability to replace Merrill Lynch Trust without first giving a release and discharge of all liability to not only Merrill Lynch Trust, but also all Merrill Lynch affiliates, or Merrill Lynch Trust would seek court approval of its conduct, at the Trust's expense.

Moreover, because the attorney did not reasonably communicate with Campbell, there was no effort or opportunity [\*6] to assess, for Campbell's benefit, the representations of Pierce and Merrill Lynch Trust upon which Campbell relied.

Merrill Lynch Trust's investment strategy was particularly aggressive for a Trust whose principal beneficiary was an elderly woman. For example, from September 1999 to July 2000, 90% of the assets were equities; for the next two years, all of the assets were equities. By 2005, largely as a result of Merrill Lynch Trust's management of the portfolio, by 2005, the value of the assets held by the Trust had declined by approximately 50%.

Campbell decided to challenge all of this. First, in March 2005, believing that the Trust performance reflected the investment decisions of Pierce, she brought an NASD arbitration against Pierce. Merrill Lynch Trust, although not a party to that arbitration proceeding, joined with Pierce in this Court in an effort to block the arbitration. Claiming that it was necessary to protect its interests, Merrill Lynch Trust interpreted the Trust documents to allow it to fund its efforts with the Trust's money. It is unclear whether Merrill Lynch Trust has allocated (if indeed it has allocated) the cost of seeking such relief between it and Pierce. [\*7] The effort to enjoin the arbitration was not wholly successful. Campbell, however, did not prevail in the arbitration forum.<sup>4</sup> Second, Campbell sought to replace Merrill Lynch Trust as trustee. Merrill Lynch Trust refused, as the Trust Agreement permitted, to allow the substitution--and transfer of Trust assets--unless Campbell released not only Merrill Lynch Trust, but also its affiliates, including Pierce.

4 The decision of the arbitrators contains the following provision: "The

Panel wishes to note that the Panel's Award in this matter should have no bearing on the Delaware court [*i.e.*, this] proceeding." PI's Opening Br. in Supp. of Mot. to Dismiss Countercl., Ex. B.

## II. THE PROCEEDINGS

Against this backdrop, Merrill Lynch Trust brought this action against Campbell, individual successor beneficiaries, and various charitable beneficiaries. It seeks approval of its accounting of its efforts since 1996 and a declaratory judgment determining that its administration of the Trust and its investment of the Trust's assets were lawful and appropriate.

Campbell counterclaimed. Raising allegations ranging from fraud to breach of fiduciary duty, she asks the Court to order a refund of all Trustee's [\*8] fees and brokerage and investment and advisory fees above going market rate; a refund of all legal fees taken by Merrill Lynch Trust from the Trust; an injunction requiring Merrill Lynch Trust to deliver the Trust corpus to a successor-Trustee; rescissory damages; and an award of the costs and expenses incurred in defending this action, defending the effort by Merrill Lynch Trust to enjoin the arbitration proceeding, and in presenting the counterclaim here.

Before the Court is Merrill Lynch Trust's Motion to Dismiss Campbell's Amended Counterclaim (the "Counterclaim"). Merrill Lynch Trust focuses on time-based defenses--laches, the general three-year statute of limitations of 10 *Del. C.* § 8106, and the two-year limitations period for claims against a trustee following a trustee's report, established by 12 *Del. C.* § 3585(a)(1). Other contentions include a failure to state a claim under Court of Chancery Rule 12(b)(6) and the failure to plead fraud with particularity, as required by Court of Chancery Rule 9(b).

## III. ANALYSIS

Merrill Lynch Trust, by filing a motion to dismiss, has assumed the burden of demonstrating that Campbell cannot prevail

even if the Court accepts all of her well-pleaded [\*9] allegations as true and gives her the benefit of inferences that can be reasonably be drawn from those allegations.<sup>5</sup> The Court, of course, need not consider conclusory allegations.<sup>6</sup> Although a motion to dismiss frequently is a less than ideal means to raise an affirmative defense, such as a time-bar defense, the Court may address such defenses if the allegations of the Counterclaim allow only one reasonable inference.<sup>7</sup>

<sup>5</sup> See, e.g., *In re Gen. Motors (Hughes) S'holder Litig.*, 897 A.2d 162, 168 (Del. 2006).

<sup>6</sup> See, e.g., *Solomon v. Pathe Commc'ns Corp.*, 672 A.2d 35, 38 (Del. 1996).

<sup>7</sup> See, e.g., *Malpiede v. Townson*, 780 A.2d 1075, 1083 (Del. 2001); cf. *Salem Church (Del.) Assocs. v. New Castle County*, 2006 WL 2873745, at \*12 (Del. Ch. Oct. 6, 2006).

Campbell's claims can be analyzed within the categories identified in the Counterclaim. First is the challenge to the inducement by representatives of Merrill Lynch Trust and Pierce of Campbell to enter into the Trust Agreement. Second is the degree of competence exhibited by Merrill Lynch Trust in developing and implementing its investment strategy. Third is the charge that Merrill Lynch Trust, without cause and in breach of its fiduciary duties, [\*10] incurred and paid with Trust funds legal fees in excess of \$ 75,000, such legal fees having been incurred primarily with respect to the effort to enjoin an arbitration to which Merrill Lynch Trust was not a party.

### A. Inducement to Establish the Trust

Campbell challenges the way in which representatives of Merrill Lynch Trust and Pierce persuaded her to enter into the Trust Agreement. Her claims sound in fraud and negligent misrepresentation, including silence when under a duty to disclose. Regardless, the applicable statute of limitations, one that equity would also borrow for laches purposes, is, as

the parties acknowledge, three years under 10 *Del. C. § 8106*. All of the alleged misrepresentations, however, occurred in 1996 and that is when the causes of action arose. These events all occurred almost ten years before Campbell filed her initial counterclaim in this proceeding. Thus, unless a basis for tolling the running of the time-bar period can be found, these claims must be dismissed.

The Delaware courts have narrowly carved limited circumstances in which the running of the limitations period can be tolled. Such tolling exceptions include the doctrines of (1) fraudulent concealment, [\*11] (2) inherent unknowable injury, and (3) equitable tolling.<sup>8</sup>

8 *Krahmer v. Christie's, Inc.*, 903 A.2d 773, 778 (Del. Ch. 2006) (citations omitted), *aff'd*, 906 A.2d 806 (Del. 2006) (TABLE).

Campbell's challenge is to demonstrate that the various alleged misrepresentations remained "unknowable" until less than three years (that is, late 2002) before she filed her counterclaim in this action.<sup>9</sup> That the lawyer retained, at her expense, for her by Pierce did not communicate with her in an appropriate fashion is obvious--at least as an objective factual matter--at the time. That the projection investment returns were not being achieved consistently was reflected in the regular reports which Merrill Lynch Trust provided to her; thus, she was on notice of the shortfalls well before late 2002. As to the various contractual rights claimed by Merrill Lynch Trust, the basis for her claim--whether Merrill Lynch Trust reads the Trust Agreement correctly or not--can be discovered from a careful reading of the document. Campbell argues that some of Merrill Lynch Trust's interpretations, such as the remedies available to her or that Merrill Lynch Trust could exclusively control the investment decisions, [\*12] are "subtle";

perhaps that is true, but subtlety does not approach unknowable. In short, none of the alleged misrepresentations or the adverse consequences that may have resulted can fairly be characterized as unknowable as late as the fall of 2002. It follows that the tolling doctrine is of no use to Campbell and her claims generally advanced in Count I of the Counterclaim are time-barred and must be dismissed.

9 Whether the Counterclaim "relates back" to Campbell's initial counterclaim is not material.

#### B. *Investment Performance*

Campbell next challenges Merrill Lynch Trust's portfolio investment strategies. She does not question any particular investment; instead, she argues that investing for the elderly requires a significant component of fixed income investments instead of the 90-100% equity investment strategy implemented by Merrill Lynch Trust. This approach, alleged by Campbell in Count II of the Counterclaim, violates the Trustee's common law and statutory fiduciary duties. Merrill Lynch Trust urges dismissal because these contentions are time-barred since the investment mix concededly was revised more than two years before the filing of the Counterclaim<sup>10</sup> and because the allegations [\*13] failed to state a claim upon which relief can be granted.

10 The two-year limitations period for the filing of claims against trustees following the sending of a trustee's report that "adequately discloses the facts constituting a claim" is prescribed by 12 *Del. C. § 3585(a)(1)*.

The expressly identified purpose for Merrill Lynch Trust's filing of this action was to obtain "[c]ourt approval of the investment decisions made by [Merrill Lynch Trust] relevant to the [Trust] period."<sup>11</sup> That question, of course, is, in substance, the same question that Campbell asked the Court to resolve. If Merrill Lynch Trust believes that there is enough of a dispute about how it managed the assets of the Trust that it brought this action, then it is difficult to

conclude that there is no issue that Campbell can fairly join. Even if Campbell had not raised the challenge asserted in her counterclaim and instead had simply relied upon confronting the complaint head on, the wisdom or propriety of the investment approach would be before the Court. If the Court in assessing whether Merrill Lynch Trust satisfied its fiduciary duties concludes that it had not done so, then the very remedies which Campbell seeks [\*14] could be ordered by the Court in the context of passing on the current accounting action. Thus, there is a viable issue to be resolved; dismissal of this portion of the Counterclaim would serve no purpose because the issue has already been joined.<sup>12</sup>

11 Compl. P 22.

12 More specifically, the Court, after giving Campbell all of the favorable inferences to which she is entitled, cannot in this context conclude that Merrill Lynch Trust did not waive any time-bar defense that it might have had. This is because Merrill Lynch Trust seeks approval of its actions all the way back to 1996; the Complaint is not limited only to its more recent investment actions. With respect to the merits of the challenge to the investment strategy, the Counterclaim alleges that the investment strategy was without any reasonable basis given the age of the primary beneficiary. Whether that, by itself, states a claim is a close question, but with the presence of Merrill Lynch Trust's direct claim raising the same issue, the better inference is that there is an issue which needs factual development before it can be addressed fairly by the Court.

### C. Attorneys' Fees

Finally, Merrill Lynch Trust argues that Campbell's [\*15] efforts to recover the legal fees that it paid from the Trust to fund the cost of the effort to enjoin the NASD arbitration and for the defense of the NASD arbitration was improper. Campbell focuses on the fact that Merrill Lynch Trust was not even designated as a party in the arbitration proceeding. No reason emerges from the Counterclaim for why a Trustee would seek to enjoin an arbitration to which it is not a party. The Trust Agreement, of course, accords Merrill Lynch Trust significant discretion and the right to incur legal fees that are to be paid from the Trust, but the Court cannot conclude from the Amended Complaint and the documents referenced in it that that Merrill Lynch Trust conduct was consistent with its fiduciary duties. Another plausible inference to be drawn from the allegations is that Merrill Lynch Trust simply decided to use funds in the Trust to pay for the litigation strategy implemented by its sister entity, Pierce. Merrill Lynch Trust's conduct may well be justified; it is simply that that conclusion cannot be reached within the confines of a motion under Court of Chancery Rule 12(b)(6).

### IV. CONCLUSION

For the foregoing reasons, Count I of Campbell's Counterclaim [\*16] (that is, the allegations of fraud and misrepresentation regarding the formation of the Trust) is dismissed. Otherwise, the motion of Merrill Lynch Trust to dismiss the Counterclaim is denied.

**IT IS SO ORDERED.**

*/s/John W. Noble*