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# Reevaluating Bonding under Section 11(e) of the Securities Act of 1933

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During the last two years, federal courts have experienced a dramatic resurgence in securities litigation filings, beginning in the latter half of 2007. Federal securities class action filings increased by 43% from 2006 to 2007, and almost two-thirds of the 2007 filings occurred during the second half of the year.[1] The data indicates that the first part of 2007 was the end of a long quiet period, at least partially attributable to a strong stock market. As the credit crises impacted the broader economy, and asset devaluation occurred, securities cases have surged since 2007 to a frequency not experienced since 2002. Approximately one-fifth of the filings in the second half of 2007 were associated with the subprime mortgage crisis that was then beginning to be felt.[2] Federal securities suits increased 19% in 2008 as compared with 2007, an increase driven largely by suits against firms tied most closely to the ongoing liquidity crisis.[3] Such suits appear likely to crest in 2009, particularly suits against financial services companies.[4]

In a direct relationship to the overall increase in securities litigation, the percentage of total class action filings which were Section 11 claims increased from 11% to 19% between 2006 and 2007 and then to 23% in 2008.[5] This trend appears to be continuing in 2009. Facing this rise in securities filings in general and Section 11 filings in particular, defense counsel will initially focus on plaintiff's pleading burdens. Counsel should also revisit a powerful but underutilized tool in actions involving a Section 11(e) claim under the Securities Act of 1933 ("1933 Act" or "Securities Act"). That tool is a motion to require a party to a suit under the Act to post an undertaking for the payment of costs, including attorney's fees, where the suit may be "without merit."[6]

This article will examine the text of Section 11(e) of the 1933 Act, assess the ways in which courts have applied the undertaking provision, and, finally, offer several al-

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ternative means by which courts might apply this provision to an end more in line with the intent behind its enactment, to provide a simple bonding mechanism with the effect of curtailing non-meritorious suits.

## The Text of Section 11

The pertinent part of Section 11(e) of the 1933 Act reads as follows:

> **"In any suit under this or any other section of this subchapter[7] the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard."[8]**

Notably, the text of this subsection grants the court discretion to require an undertaking, conditioning this discretion solely on the court's belief that the suit or defense in question lacks merit.[9] This provision did not appear in the original 1933 Act; it was introduced as an amendment to Section 11 in connection with adoption of the Securities Exchange Act of 1934 ("1934 Act" or "Exchange Act"). At the time, Sen. Duncan Fletcher (D-Fla.), Chairman of the Senate Banking and Finance Committee, referred to this amendment as "the most important of all," noting that one of its purposes was to serve "as a defense against blackmail suits."[10]

The Supreme Court has emphasized both the broad authorizing language of Section 11(e) and the comments of Sen. Fletcher regarding that subsection in explaining the logic behind its holdings in two seminal cases interpreting the Securities and Exchange Acts. In *Blue Chip Stamps v. Manor Drug Stores*, the Court cited the amended Section 11(e), and Sen. Fletcher's accompanying statement, as evidence of a concern on the part of the drafters of the 1933 and 1934 Acts about the danger of nuisance or strike suits brought under the Acts.[11]

Soon thereafter, in *Ernst & Ernst v. Hochfelder*, the Court cited to the same sources to distinguish the express civil remedies of the 1933 Act and the judicially implied cause of action for securities fraud under Section 10(b) of the 1934 Act on the basis that the former causes of action are subject to the significant and carefully drafted procedural restriction of Section 11(e) where the latter cause of action is not.[12] Additionally, the Supreme Court has noticed and allowed overlap between Section 11 and Section 10(b) causes of action,[13] noting the possibility that the undertaking provision of Section 11 has encouraged would-be Section 11 plaintiffs to seek refuge in other causes of action, explicit and implicit, under the Securities and Exchange Acts.[14] The SEC suggested in 1993 that the U.S. Senate Subcommittee on Securities consider whether to amend Section 10(b) to include a similar fee-shifting provision to "defer frivolous claims without having a significant chilling effect on meritorious actions."[15] Nonetheless, this material difference between Section 11 and Section 10(b) cases persists.

## Section 11 as Applied

United States District Courts and Courts of Appeals have rarely discussed the undertaking provision of Section 11(e). Only in the exceptional case has a court granted a motion for an undertaking, and even in such cases the courts have emphasized their unwillingness to grant such a motion.[16] Courts reviewing motions for undertakings under Section 11(e) often apply the stringent test employed by District Judge Joseph F. Gagliardi in *Straus v. Holiday Inns, Inc.*, requiring that the action be brought in bad faith or be "so utterly lacking in merit as to border on the frivolous."[17]

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In determining whether a claim was brought in bad faith, courts consider, *inter alia*, whether there is clear evidence that a claim is entirely without color and was made for reasons of harassment, delay or other improper purposes.[18] The evaluating court assesses the conduct of the party bringing the claim for indicators of bad faith such as "its pursuit of frivolous contentions, or procedural bad faith as exhibited by, for example, its use of oppressive tactics or its willful violations of court orders."[19] Making a determination under the alternative standard, whether the claim "borders on the frivolous," requires that a court evaluate the factual and legal barriers to the plaintiff's recovery,[20] such as elements of the claim that cannot be made out or affirmative defenses that cannot be overcome.

The set of generally accepted standards used to date by district courts on a motion for an undertaking at the pre-judgment stage are far stricter than required on the face of Section 11(e), which more simply, and less onerously, states that "the court may, in its discretion, require an undertaking for the payment of the costs of such suit"[21]

The two events contemplated by Section 11(e)—bonding at the outset, and costs at judgment—differ starkly in their timing and effect on the parties. A pre-judgment undertaking is preliminary based on an initial evaluation of the merits based on pleadings and affidavits. This is not a draconian remedy; it does not take away anything from a plaintiff. Rather, it simply provides the defendant some protection in the form of security for payment if the case turns out to be one that requires assessment of costs.

Ordering payment of costs occurs only after a final disposition on the merits. A court considering an undertaking must by definition proceed with less information than a court considering an order for payment of costs, and such an order is only provisional or protective in nature.

Notwithstanding the very different remedies (one that merely gives the defendant security and one that actually makes an award), the courts consistently have applied the same *Straus* test[22] in both situations.[23] Courts thus strain to apply a standard fashioned for punitive post-judgment relief even where relatively harmless preliminary provisional relief is sought in the form of an undertaking. Application of an unduly restrictive standard at the preliminary stage should not be allowed to functionally moot the undertaking provision of Section 11(e).

In *Philips v. Kidder Peabody & Co.*, the court declined to require the payment of an undertaking on the basis that the motion was made too early, stating, "At this early stage of the case and in light of the paucity of the record, the court is loathe to make a finding that the instant action was brought in bad faith or borders on the frivolous."[24] The court then preemptively defended its denial of the motion for the provisional bonding on the basis that Section 11(e) allows the court "to impose the costs of the litigation after a judgment in favor of the defendant, even absent an undertaking."[25] By this logic, a motion for an undertaking is always inevitably both premature (because the record is incomplete) and unnecessary (because the court can order post-judgment payment of costs). This, of course, assumes that all plaintiffs bring suits in good faith and are willing and able to pay costs should the court order them to do so. This is not the case. *Philips* ignores the important gate-keeping purpose that the drafters intended for the undertaking—to weed out plaintiffs unwilling to "put their money where their mouth is."

## Superior Approaches to the Application of Section 11

Though courts have been consistent in following it, the *Straus* test traces back to a small number of old opinions, most of which were issued by district courts and none of which came from the Supreme Court.[26] Because of the broad discretion


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granted to them by statute and the relative paucity of authority for the current standard, courts should look beyond the language of *Straus* and its progeny and consider the language and purpose of the statute to develop a more appropriate standard.

One proposed standard, presented by the defendants but rejected in *Straus*, draws from *Blue Chip Stamps* and *Hochfelder* and would require that "if a complaint, considered by objective standards, presents a possibility of vexatious litigation because it appears to have little chance of success at trial, then a court should exercise its discretion to require the plaintiff to post a bond for the payment of defendants' costs and expenses."[27] The *Straus* court declined to follow this test, stating that neither *Blue Chip Stamps* nor *Hochfelder* compelled such a standard or articulated any other standard guiding the application of Section 11(e) and that every court previously construing Section 11(e) has applied the "bad faith bordering on the frivolous standard."[28] Though *Blue Chip Stamps* and *Hochfelder* did not announce a standard, their highlighting of the important gatekeeping function of Section 11(e) and citation to the statements of Sen. Fletcher suggests potential receptivity to an alternative test more closely tied to the text of Section 11(e) and the legislative history. If the purpose of Section 11(e) is to grant courts broad discretion to require an undertaking and thereby discourage vexatious litigation, then the broadly discretionary but goal-oriented language proposed by the *Straus* defendants' seems well aligned with that purpose.

Another model that the courts might follow is that of the Southern District of New York's Local Rule 54.2, which grants the court discretion to "order any party to file an original bond for costs or additional security for costs in such an amount and so conditioned as it may designate." This rule is designed to assure "that a successful defendant will at least be able to recoup its costs."[29] The factors that courts have considered in applying Rule 54.2 include: whether the party is likely to pay; the legal costs expected to be incurred; the merit of the underlying claims; and compliance with past court orders.[30] Though the discretion granted the court under Rule 54.2 is not limited, as is Section 11(e), to suits "without merit," nor tied to a specific statute like the Securities Act, the differences are not so great as to render Rule 54.2 unhelpful as a model. Courts weigh ordering a bond under Rule 54.2 after considering a non-exhaustive list of factors compiled from previous decisions focusing on assuring that a prevailing defendant's costs will be paid.[31]

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Rather than apply the exclusive two-factor *Straus* test, which severely inhibits the effective use of Section 11(e)'s undertaking provision, district courts applying Section 11(e) could use the discretion granted them by statute to consider the merits of: the likelihood of eventual success on the merits; whether the existing record supports or undermines the allegations contained in the complaint; the plaintiff's litigation history; or, in the case of a class action, the likelihood that a class will be certified. The list of factors considered by such a test should be exemplary rather than exclusive. This would allow district courts to apply Section 11(e) with the flexibility and discretion that the drafters of the Securities Act intended.

Finally, courts could take an incremental approach by applying the existing standard in a manner that gives weight to their broad discretion to consider the preliminary and reversible nature of the relief requested and the early point in the litigation at which a motion for an undertaking is typically made.

For example, in *Weil v. Investment/Indicators, Research and Management, Inc.*, the Ninth Cir-

cuit Court of Appeals cited the test from *Straus* but emphasized that "an order requiring an undertaking need not be based on a formal, factual finding that the claim or defense is obviously without merit or is asserted in bad faith; such a finding is premature and inappropriate at the time when the decision whether to require an undertaking must be rendered."[32] The *Weil* court made a practical application of the *Straus* test early in the case and before a significant record has developed, at which moment a motion to require an undertaking will come before a district court. Acknowledging that this test must be applied on the basis of a partial record, the court required only "that an eventual finding of bad faith *or* obvious lack of merit *appear likely* to the district court in view of the evidence before it."[33] Importantly, this disjunctive language allows a defendant to successfully move the court to require an undertaking based on a showing that either eventual finding appears likely. By requiring a less formal and certain showing from a successful motion for an undertaking, the *Weil* court treated the motion in a manner appropriate to its preliminary nature, thereby differentiating it from a motion for post-judgment payment of costs. Such a modified application of the *Straus* test represents an incremental departure from the status quo. This is a step in the right direction.

Courts should not unfairly burden plaintiffs who have filed suits with legal and factual basis, diligent inquiry, and good faith, and such plaintiffs' day in court should not be unnecessarily cut short for financial reasons. But the mere posting of a bond as security for costs, on an appropriate showing, does not threaten such harm, and safeguards are readily available.[34] Meritless suits burden the courts and impose heavy costs on defendants, often for reasons of cost and prospect of collection without the eventual repayment of those costs by plaintiffs who are legally obligated to pay. Section 11(e) provides a mechanism to mandate repayment of such costs where the suit appears to lack merit or a good faith basis. This subsection has unfortunately fallen largely out of use in light of the current standard. A new standard more carefully tailored to the preliminary nature of the remedy would allow federal courts to use this important case management tool.

**NOTES**

1. Cornerstone Research, Securities Class Action Case Filings, 2007: A Year in Review 2 (2008), http://securities.stanford.edu/clearinghouse_research/2007_YIR/20080103-01.pdf.
2. Cornerstone Research, at 2–3.
3. Cornerstone Research, Securities Class Action Case Filings, 2008: A Year in Review 2 (2009), http://securities.stanford.edu/clearinghouse_research/2008_YIR/20090106_YIR08_Full_Report.pdf.
4. ADVISEN, SECURITIES LITIGATION SURGES IN 2009, QUARTERLY REPORT – Q1 2009 (2009), http://corner.advisen.com/pdf_files/SecuritiesLitigationQuarterly2009Q1050109Final.pdf.
5. Securities Class Action Case Filings, 2007: A Year in Review at 20–21; Securities Class Action Case Filings, 2008: A Year in Review at 21.
6. Securities Act of 1933, 15 U.S.C.A. § 77k (e).
7. The "subchapter" referred to is Subchapter I ("Domestic Securities") under Chapter 2a ("Securities and Trust Indentures") of Title 15 of the United States Code ("Commerce and Trade"), which subchapter may be cited as the "Securities Act of 1933." 15 U.S.C.A. § 77a. Thus, the application of a Section 11(e) undertaking is available, upon a proper showing, in any case, under the 1933 Act.
8. Securities Act of 1933, 15 U.S.C.A. § 77a.
9. *See also Stitt v. Williams*, 919 F.2d 516, Fed. Sec. L. Rep. (CCH) P 95647, R.I.C.O. Bus. Disp. Guide (CCH) P 7631, 18 Fed. R. Serv. 3d 1320 (9th Cir. 1990)("Section 11(e) provides only that the district court 'may' award fees, not that it must. The statutory language leaves the district courts broad discretion to consider and balance the relevant facts and policies. We will not disturb the district court's discretion unless we have a definite and firm conviction that the court committed a clear error of judgment in the conclusion it reached after a weighing of the relevant factors.") (citing Fjelstad v. American Honda Motor Co., Inc., 762 F.2d 1334, 1337, 2 Fed. R. Serv. 3d 196 (9th Cir. 1985)).
10. 78 Cong. Rec. 8669.
11. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740, 95 S. Ct. 1917, 44 L. Ed. 2d 539, Fed. Sec. L. Rep. (CCH) P 95200, 1975-1 Trade Cas. (CCH) ¶ 60351 (1975).


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12. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208–210, 210–211 n.30, 96 S. Ct. 1375, 47 L. Ed. 2d 668, Fed. Sec. L. Rep. (CCH) P 95479 (1976).
13. Herman & MacLean v. Huddleston, 459 U.S. 375, 387, 103 S. Ct. 683, 74 L. Ed. 2d 548, Fed. Sec. L. Rep. (CCH) P 99058 (1983).
14. In at least one case, a court has commented that a plaintiff "obviously" brought suit under Section 10(b) rather than Section 11 to avoid the provision of Section 11(e) allowing the court to require an undertaking. *Montague v. Electronic Corp. of America,* 76 F. Supp. 933, 935 (S.D. N.Y. 1948). One commentator asserts that such a flight from Section 11 occurs regularly. Thomas S. Loo, *Acquisitions and Mergers in a Changing Environment: Potential Remedies in Acquisition Transactions*, Practicing Law Institute, PLI Order No. B4-6931, at 621 (July–Aug. 1990).
15. *Private Litigation Under the Federal Securities Laws*, 103rd Cong., 8 Hrng. 103-431, at 38-39, 117-18 (1993) (statement of William R. McLucas, Div. of Enforcement, SEC).
16. *See, e.g.*, *Straus v. Holiday Inns, Inc.*, 460 F. Supp. 729, 732, Fed. Sec. L. Rep. (CCH) P 96383 (S.D. N.Y. 1978)("An application for an undertaking generally 'is not looked upon with favor.'") (quoting *Lerner v. Ripley & Co.*, (1961–1964) Fed. Sec. L. Rep. (CCH) P 91,249, at 94,127 (S.D.N.Y. 1963).
17. *Straus v. Holiday Inns, Inc.*, 460 F. Supp. at 732; *see also Currie v. Cayman Resources Corp.*, 595 F. Supp. 1364, 1379, Blue Sky L. Rep. (CCH) P 72166, Fed. Sec. L. Rep. (CCH) P 91900 (N.D. Ga. 1984) (citing *Straus*, 460 F. Supp. at 732–733).
18. *See Western Federal Corp. v. Erickson*, 739 F.2d 1439, 1444, Fed. Sec. L. Rep. (CCH) P 91611 (9th Cir. 1984)(granting costs under the alternative "borders on the frivolous" standard); *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 277 (10th Cir. 1957).
19. *I.G. Farben Shareholders Organization v. UBS AG*, 2006 WL 2828558, at *7 (E.D. N.Y. 2006)(quoting *Dow Chemical Pacific Ltd. v. Rascator Maritime S.A.*, 782 F.2d 329, 345, 1986 A.M.C. 1445, 4 Fed. R. Serv. 3d 583 (2d Cir. 1986)).
20. *Straus*, 460 F. Supp at 733.
21. 15 U.S.C.A. § 77k (e).
22. We refer to the test for either bad faith or lack of merit bordering on the frivolous as the "*Straus* test" regardless of whether a particular decision actually cited to *Straus*.
23. *Cf. Zissu v. Bear, Stearns & Co.*, 805 F.2d 75, 80, Fed. Sec. L. Rep. (CCH) P 92995 (2d Cir. 1986) (awarding attorneys' fees and costs under Section 11(e) where a court holds a suit is without merit because it finds that "the claim is frivolous or brought in bad faith).
24. Phillips v. Kidder, Peabody & Co., 686 F. Supp. 413, 416 (S.D. N.Y. 1988).
25. *Philips*, 686 F. Supp. at 416–417.
26. *See Straus*, 460 F. Supp. at 732 (citing *Klein v. Shields & Co.*, 470 F.2d 1344, 1347, Fed. Sec. L. Rep. (CCH) P 93692, 23 A.L.R. Fed. 977 (2d Cir. 1972)); *Katz v. Amos Treat & Co.*, 411 F.2d 1046, 1056, Fed. Sec. L. Rep. (CCH) P 92409, 6 U.C.C. Rep. Serv. 533 (2d Cir. 1969); *Linchuck v. Cooper*, 43 F.R.D. 382, 384 (S.D. N.Y. 1967). Searches on the Westlaw "KeyCite" and LexisNexis "Shepard's" services show that *Straus* has been cited in only one decision in the past decade, and was there cited to support a proposition not related to the holding here at issue. *In re Bausch & Lomb, Inc. Securities Litigation*, 2003 WL 231017822, at *25 n.24 (W.D. N.Y. 2003).
27. *Straus*, 460 F.Supp. at 732–33 n.2.
28. *Straus,* 460 F. Supp. 729.
29. *Livnat v. Lavi*, 44 U.S.P.Q.2d 1379, 1997 WL 563799, at *3 (S.D. N.Y. 1997).
30. *See Top Mount Development Ltd. v. Helix North American, Inc.*, 2002 WL 570897, at *1 (S.D. N.Y. 2002)(citing Selletti v. Carey, 173 F.R.D. 96, 100-101, 43 U.S.P.Q.2d 1269, 38 Fed. R. Serv. 3d 903 (S.D. N.Y. 1997), aff'd, 173 F.3d 104, 43 Fed. R. Serv. 3d 608 (2d Cir. 1999)).
31. *See Herbstein v. Bruetman*, 141 F.R.D. 246, 247 (S.D. N.Y. 1992)("This list is by no means exhaustive, nor is each factor considered in every case.")(applying the precursor to Rule 54.2).
32. Weil v. Investment/Indicators, Research and Management, Inc., 647 F.2d 18, 22, Fed. Sec. L. Rep. (CCH) P 98023, 8 Fed. R. Evid. Serv. 475, 31 Fed. R. Serv. 2d 1196 (9th Cir. 1981).
33. *Weil,* 647 F.2d 18 (emphasis added).
34. The models discussed would require a showing that the suit was vexatious, meritless, or brought in bad faith. All of these models grant courts the discretion to reduce or eliminate an undertaking where to do otherwise would threaten the plaintiff's ability to access the courts. *See, e.g.*, Mann v. Levy, 776 F. Supp. 808, 815 (S.D. N.Y. 1991)("Recognizing that the amount of the bond should not 'seriously impede' plaintiff's ability to prosecute the action, in the exercise of our discretion, we direct plaintiff to post a single $10,000 security bond running both to Republic and Levy.").

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