Westlaw Journal

SECURITIES LITIGATION & REGULATION

Litigation News and Analysis • Legislation • Regulation • Expert Commentary

VOLUME 20, ISSUE 11 / OCTOBER 2, 2014

WHAT'S INSIDE

41562246

COMMENTARY

Judge Rakoff as Don Quixote? Tilting at the SEC's settlement windmills

C. Evan Stewart of Cohen & Gresser discusses the efforts and potential outcomes of U.S. District Judge Jed Rakoff's attempts to stop the Securities and Exchange Commission from asking Article III judges to "rubber-stamp" regulatory settlements.

SEE PAGE 3

U.S. District Judge Jed Rakoff REUTERS/Victoria Will

SECURITIES FRAUD

Judge tosses suit against U.S. chipmaker over Chinese labor shortage

By Jason Seashore, J.D., Senior Content Writer, Westlaw Daily Briefing

Diodes Inc. has convinced a Texas federal judge to dismiss allegations the U.S. semiconductor maker defrauded investors by failing to disclose the full scope of a labor shortage at its facility in China that ultimately hurt revenues and profits.

Local 731 I.B. of T. Excavators and Pavers Pension Trust Fund v. Diodes Inc. et al., No. 13-247, 2014 WL 4635586 (E.D. Tex. Sept. 15, 2014).

While the facts alleged in the complaint may have created some inference of fraudulent intent, they could not overcome an "even stronger" inference that Diodes' senior management simply miscalculated the degree and duration of the labor problems, U.S. District Judge Michael H. Schneider of the Eastern District of Texas said in the ruling.

Lead plaintiff Local 731 I.B. of T. Excavators and Pavers Pension Trust Fund sought compensation on behalf of investors who lost money on Diodes shares purchased during a four-month period ending June 9, 2011.

CONTINUED ON PAGE 16

Westlaw Journal Securities Litigation & Regulation

Published since September 1995

Publisher: Mary Ellen Fox

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Westlaw Journal Securities Litigation & Regulation (ISSN 2155-0042) is published biweekly by Thomson Reuters.

Thomson Reuters
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Wayne, PA 19087
877-595-0449
Fax: 800-220-1640
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TABLE OF CONTENTS

Judge Rakoff as Don Quixote? Tilting at the SEC's settlement windmills

By C. Evan Stewart, Esq.
Cohen & Gresser

U.S. District Judge Jed S. Rakoff's frustration with the way the federal government has handled (or mishandled) the 2008-09 financial crisis has been well documented.[1] The focus of this commentary, however, is his multi-year attempts to push back at the Securities and Exchange Commission's historical practice of seeking to have Article III judges approve regulatory settlements.

For over 40 years, the SEC has, as a matter of course, entered into settlements with corporations. These settlements have, at their core, two features: the corporations neither admit nor deny liability, and the SEC asks a federal district court judge to ink his or her signature on the settlement, thereby triggering the judge's injunctive/contempt power vis-à-vis future violations of law.

The first component has traditionally been justified on two grounds. First, it saves the SEC resources by not having to litigate and prove wrongdoing at trial. Second, it allows corporations the ability thereafter to litigate tag-along civil litigation brought by private plaintiffs (and the plaintiffs' bar).

The second component is more of a historical artifact; it dates back to a time when the SEC had very few weapons in its enforcement arsenal to penalize and deter corporate wrongdoing.

THIRD TIME'S THE CHARM?

In 2009 it looked like at least part of this settlement protocol was going to be affected when Judge Rakoff rejected a $33 million settlement between the SEC and Bank of America. According to the SEC, Bank of America had "materially lied" to its shareholders. Prior to a Dec. 5, 2008, vote on Bank of America's proposed acquisition of Merrill Lynch, Bank of America had failed to disclose that $5.8 billion in bonuses were to be paid to Merrill Lynch employees. In rejecting the settlement, Judge Rakoff said it did "not comport with the most elementary notions of justice and morality."[2]

> Judge Jed Rakoff said the "disservice to the public interest in such a [settlement] practice is palpable."

The judge was upset that Bank of America shareholders were both victimized and being made to bear the financial penalty for the alleged misconduct. Therefore, he ruled that the settlement was merely "a contrivance designed to provide the SEC with the façade of enforcement and the management of the bank with a quiet resolution of an embarrassing inquiry."[3]

Ultimately, in 2010 — only after Bank of America had worked hard to meet all his demands — Judge Rakoff grudgingly approved a $150 million settlement; by then, it hardly seemed like an SEC triumph.[4]

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Two years later, in March 2011, the SEC again found itself before Judge Rakoff with a settlement he found less than compelling. Judge Rakoff decided to approve the settlement, largely because two of the individuals involved had pleaded guilty to related criminal charges, and the company, despite being destitute, had paid a multimillion-dollar penalty. He said, however, that the "disservice to the public interest in such a [settlement] practice is palpable."[5]

More generally, Judge Rakoff decried the SEC seeking a federal court's imprimatur on such settlements, tracing the rationale for that approach back to the above-referenced era when the commission's enforcement powers were limited. The SEC's current enforcement powers are now both wide and deep, and they can be invoked without ever having to go to court.

Later that same year, the SEC filed a complaint in federal court in New York, charging Citigroup with securities fraud in connection with a synthetic collateralized debt obligation sold to investors in 2007.[6] Simultaneously with the court filing, the SEC did the following:

- Announced it was settling the matter with Citigroup for $285 million.
- Filed a separate lawsuit against a former Citigroup employee it claimed was the principal individual responsible for the CDO fraud.
- Instituted settled administrative proceedings against two Credit Suisse entities and a Credit Suisse employee for their roles in the CDO transaction.

The judge who drew the task of overseeing and approving the SEC's settlement with Citigroup was again Judge Rakoff.

At the same time the SEC was going public with its spin on the resolution of this allegedly fraudulent securities transaction, Citigroup issued its own press release. In addition to the settlement tracking the traditional mantra of neither admitting nor denying wrongdoing, Citigroup highlighted for the investing public the fact that the SEC had not charged the company with "intentional or reckless misconduct."

Perhaps in response to the foregoing (how can a securities fraud of this nature and magnitude be the result simply of negligence?), Judge Rakoff scheduled a settlement hearing. In advance, he asked the settling parties to answer nine questions relating to whether the settlement was "fair, adequate and reasonable." Not satisfied with the answers he received, Judge Rakoff rejected the settlement,[7] which was appealed by both the SEC and Citigroup.

THE 2ND CIRCUIT'S 'REBUKE'

On June 4 the 2nd U.S. Circuit Court of Appeals vacated Judge Rakoff's order and sent the settlement back to him for "further proceedings in accordance" with the appellate court's ruling.[8] The publicity attendant to the ruling termed it as a frontal "rebuke" of Judge Rakoff. But was it really?

On this last point, the district judge must first determine that it is "fair and reasonable." The 2nd Circuit laid out four indicia to measure those concepts:

- Whether the settlement has a basis in law.
- Whether its terms are clear.
- Whether it resolves the actual claims in dispute.
- Whether it is tainted by some form of collusion or corruption.

Finally, if the court's injunctive/contempt powers are invoked, the judge is also to determine that the "public interest would not be disserved" by the settlement. The 2nd Circuit then concluded that "[a]bsent a substantial basis in the record" that the settlement fails to meet these requirements, a district judge "is required to enter the order."

BACK TO JUDGE RAKOFF

Obviously not thrilled with the vacatur and remand, Judge Rakoff started off his three-page opinion Aug. 5 with a caustic statement: "They who must be obeyed have spoken." Applying the "modest standard[s] imposed" by the higher court, Judge Rakoff then approved the settlement. He concluded by wondering whether courts going forward would entertain "no meaningful oversight whatsoever" on such matters; but, given that the 2nd Circuit had "fixed the menu," he was left "with nothing but sour grapes."[10]

> The SEC's current enforcement powers are now both wide and deep, and they can be invoked without ever having to go to court.

Clearly, on one front, the 2nd Circuit ruled that Judge Rakoff had overstepped his authority in criticizing and rejecting the SEC's policy of not requiring the settling party to admit to legal wrongdoing. In other words, it was an abuse of discretion for Judge Rakoff to require the SEC to prove the "truth" of its claims against Citigroup.

But on three other fronts, the Court of Appeals pretty much lined up with Judge Rakoff. The court cautioned the SEC that it might want to rethink its reflexive approach of always going into federal court to seek judicial approval of settlements. It is not necessary, and the SEC never seems thereafter to invoke the court's injunctive/contempt powers.[9]

The court also agreed with Judge Rakoff that if the SEC continues to come into federal court in such circumstances, the district judge is not to be a mere "potted plant," but to play a role in assessing the settlement. Finally, the court articulated standards as to what the district judge is to employ in reviewing such settlements.

WHERE TO NOW?

Judge Rakoff's original shot across the SEC's bow in 2011 emboldened a number of other Article III judges to take on a more active oversight role in evaluating SEC settlements. In fact, judges in Washington, D.C., and Colorado — courts outside the jurisdictional/precedential scope of the 2nd Circuit — have followed Judge Rakoff's rationale in rejecting SEC settlements.[11]

Whether going forward the 2nd Circuit's standards will be the guideposts for the federal judiciary throughout the country remains to be seen.

Another fallout from Judge Rakoff's settlement offensive is that the SEC seems to have figured out (finally) that it need not always go to federal court to mete out the regulatory justice it wants to impose. In many areas, including insider trading cases, it has now started to invoke its own administrative law process and procedures.

While this trend may be troubling with respect to due process and other rights in certain types of cases (*e.g.*, insider-trading cases), it certainly makes sense with respect to settlements. By going this route, all the SEC is giving up is something it never used anyway, the contempt "teeth" to punish corporate recidivism.[12]

Thus, perhaps because of Judge Rakoff's tilting at the SEC's settlement windmills, he will have achieved what he wanted in the first place: fewer regulatory settlements being brought before Article III judges for review and approval. WJ

NOTES

[1] *See* Jed Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?* N.Y. Review of Books, Jan. 9, 2014; Jed Rakoff, *Why Have Top Executives Escaped Prosecution?* N.Y. Review of Books, Apr. 3, 2014.

[2] *See* C. Evan Stewart, *Pandora's Box and the Bank of America*, N.Y.L.J., Nov. 4, 2009.

[3] *Id.*

[4] *See* John C. Coffee Jr., *Illusory Victories? Do SEC Settlements Deter?* N.Y.L.J., Nov. 18, 2010.

[5] *See* C. Evan Stewart, *The SEC and Litigation: Oil and Water?* N.Y.L.J., Nov. 8, 2011.

[6] *Id.*

[7] *SEC v. Citigroup Global Mkts.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011).

[8] *SEC v. Citigroup Global Mkts.*, 752 F.3d 285 (2d Cir. June 4, 2014).

[9] *See* Edward Wyatt, *S.E.C. Is Avoiding Tough Sanctions For Large Banks*, N.Y. Times, Feb. 3, 2012.

[10] *SEC v. Citigroup Global Mkts.*, No. 11–cv–7387, 2014 WL 3827497 (S.D.N.Y. Aug. 5, 2014).

[11] *See, e.g., SEC v. Van Gilder*, No. 12–cv–02839, 2014 WL 1628474 (D. Colo. Apr. 24, 2014).

[12] Indeed, the day after Judge Rakoff's "approval" of the Citigroup–SEC settlement, the SEC granted Citigroup relief under the 1940 Investment Advisers Act from the effects of the settlement for purposes of its activities as an investment adviser.

Bank of America settlement the latest and largest example of the 'shadow regulatory state'

By James R. Copland and Isaac Gorodetski,
Manhattan Institute Center for Legal Policy

While much of America was on vacation, the U.S. Department of Justice, on Aug. 21, announced a record $16.65 billion agreement that resolved civil claims alleging that Bank of America improperly concealed the risks of mortgage-related securities when it sold them to large institutional investors before and after the 2008 financial meltdown. The agreement was hardly unique; other government entities announced unrelated settlements with Goldman Sachs and Standard Chartered bank in July, and earlier this year, the Justice Department announced similar mammoth settlements with JPMorgan Chase ($13 billion) and Citigroup ($7 billion) over conduct parallel to that called out in the Bank of America agreement.

Bank of America alone has now entered into 19 settlements to resolve various lawsuits related to the financial meltdown — many stemming from the bank's crisis-era acquisitions of mortgage lender Countrywide Financial and investment bank Merrill Lynch — with a total tab of almost $75 billion.

In the broader context, the federal government now regularly enters into such agreements with large corporations, including both civil settlements and "deferred prosecution" or "non-prosecution" agreements resolving criminal charges. Although such agreements have been concentrated in the financial sector — which saw 13 DPAs in 2012 and 2013 — their scope has been much broader. Over the last five years, 10 of the 100 largest U.S. companies by revenues, including Archer Daniels Midland, CVS Caremark, Google, Johnson & Johnson, Merck, Pfizer, Tyson Foods and UPS, have reached DPAs or NPAs with the federal government.

> What we have called "the shadow regulatory state" is a new approach to business regulation and prosecution of wrongdoing in the United States.

BACKGROUND

The Aug. 21 Bank of America settlement, like the earlier mammoth mortgage-securitization settlements reached with JPMorgan Chase and Citigroup for similar conduct, does not directly involve the corners that the mortgage industry undoubtedly cut in lending during the latter stages of the housing bubble. Rather, the underlying claim is that Bank of America sold mortgage-backed securities with risks that the bank was aware of but failed to disclose.

The alleged transactions occurred both before and after the financial crisis, and involved both Bank of America itself (to the total of an alleged $850 million) and chiefly its subsequently acquired subsidiaries Countrywide and Merrill Lynch. The counterparties to these sales were not ordinary investors but sophisticated parties: insurance companies, pension funds, university endowments, and the like, including the government-sponsored enterprises Fannie Mae and Freddie Mac.

Although Bank of America and the other large banks packaging and selling mortgage-backed securities have been understandably loath to test the government's theory in court, it is likely that they and the large investors buying these instruments were all relying on backward-looking but historically thin statistical models that failed to anticipate accurately the probability and effects of a general nationwide housing-price decline.

The government can produce emails and other evidence that some individuals in the banks were skeptical of the mortgages being packaged, but that hardly suggests that each large American bank, in parallel, was engaged in an effort to dupe sophisticated counterparties.

The government does not allege that the banks were placing large derivative bets against the very instruments they were selling — which they would not have hesitated to do


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were their trading desks convinced that the securities were junk. (In Bank of America's case, the picture is further complicated by the fact that most of the alleged wrongdoing originated from two predecessor financial institutions, Countrywide and Merrill Lynch, which the bank swallowed up in the heat of the financial crisis with much prodding from the federal government itself.)

THE RISE OF NEGOTIATED SETTLEMENTS AND DPA

As noted at the outset, Bank of America's settlement is distinctive only for its size. Through agreements with large companies that are afraid to take on the government in court, the Department of Justice has regularly been imposing hefty "fines" on companies without trial and with minimal transparency. And government attorneys have been prompting major shifts in business practices to some of our nation's largest companies — indeed, entire industries — with virtually no congressional guidance or judicial oversight. What we have called "the shadow regulatory state" is a new approach to business regulation and prosecution of wrongdoing in the United States.

After federal DPAs were introduced by President Bill Clinton's Justice Department in 1993, they were used sparingly; the government entered into only 17 DPAs in the first decade. Since Arthur Andersen's ill-fated prosecution — the U.S. Supreme Court ultimately overturned the firm's conviction but not until long after the accountancy had closed its doors as a result of the prosecution — they have proliferated: Over the last decade, there have been over 300 DPAs and NPAs reached between the government and American and foreign businesses (see graph).

PUNISHMENT WITHOUT TRIAL

In a notable case in which the Justice Department did prosecute a former GlaxoSmithKline general counsel for conduct related to an underlying settlement, a federal judge threw out the case against with harsh criticism of the government's actions. *United States v. Stevens*, 771 F. Supp. 2d 556 (D. Md. May 10, 2011). The government's theory underlying the broader GSK investigation was itself dubious, alleging that it was illegal for the company to disseminate truthful information about pharmaceutical

> DPAs, NPAs, and their civil analogues allow prosecutors to make big headlines "punishing" companies while they avoid testing theories of wrongdoing or liability in court.

Why are such settlements so commonplace? If a key lesson of the 2008 crisis was the perils of an economy in which certain large financial institutions are "too big to fail," a key lesson prosecutors and business executives alike took from the 2002 collapse of the large accounting firm Arthur Andersen after it was indicted for its Enron audits was that many companies are "too big to jail."

Businesses prefer to settle rather than face trial. Government investigations distract senior management, impair credit, depress stock prices and, in cases of criminal indictment or conviction, can cause companies to lose essential government licenses or to be excluded from government reimbursement or contracts. (The threat of potential criminal indictment hovers over any government investigation, strengthening the government's hands to extract more dollars from companies even in civil settlements, like Bank of America's, which reserve future criminal-prosecution authority.)

indications not listed on the label approved by the Food and Drug Administration.

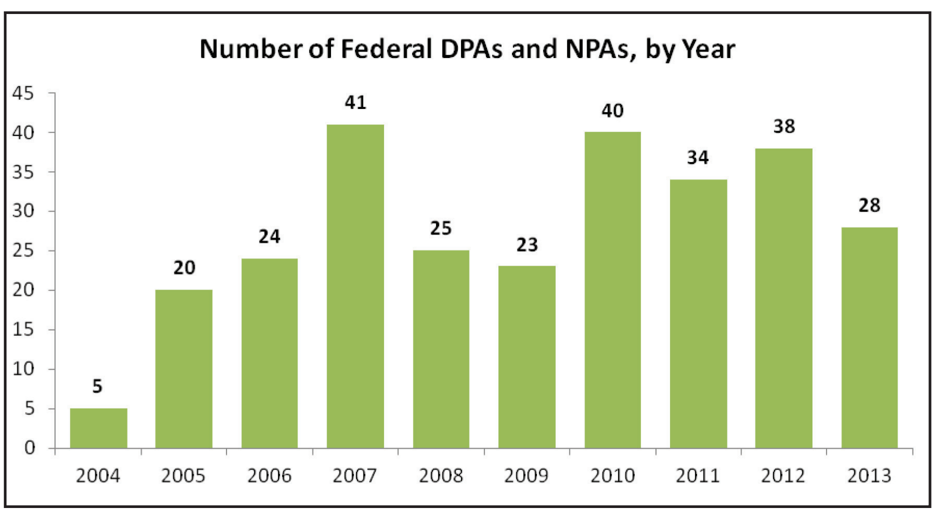
In December 2012, the 2nd U.S. Circuit Court of Appeals reversed the conviction of a pharmaceutical sales representative for such an offense, on First Amendment grounds — but not before GSK had agreed to a $3 billion settlement. *United States v. Caronia*, 703 F.3d 149 (2d Cir. Dec. 3, 2012).

In any individual case, shareholders may well be better off when managers cut a deal with prosecutors, given the risks of trial. Bank of America's stock, for instance, jumped 4 percent on the day its $16.65 billion settlement was announced.

But DPAs, NPAs and their civil analogues allow prosecutors to make big headlines "punishing" companies while they avoid testing theories of wrongdoing or liability in court. And in "cooperating" with government investigators, corporate managers may be using shareholders' dollars to protect themselves; the number of individuals prosecuted for misconduct related to multibillion-dollar corporate settlement agreements remains vanishingly small.

Even in cases in which statutory text and legal precedent would seem to provide a safe harbor for a company in the government's cross hairs, corporate managers are likely to prefer settling to going to trial. That's what Ralph Lauren did last year, when it was accused of employing subcontractors that illegally bribed Argentine customs officials to smooth the import and export of the company's clothing lines. Although such conduct is certainly morally objectionable, and against the law in Argentina, it is not likely illegal under American law.

The operative federal statute, the 1977 Foreign Corrupt Practices Act, expressly exempts low-level "facilitating payments" designed "to expedite or secure the performance of a routine governmental action by a foreign official," and both the plain text of the statute and a 5th Circuit



legal precedent would seem to exempt the company's alleged transgressions from U.S. government prosecution. *United States v. Kay*, 359 F.3d 738 (5th Cir. Feb. 4, 2004). But given the company's decision to settle, we'll never know for sure.

APPROPRIATIONS WITHOUT CONGRESS

Bank of America's settlement exemplifies another feature of government settlements with large companies that troubles us: The monies paid out do not merely flow into the government's coffers but generate a large pool of resources for the executive branch to appropriate as it sees fit, without congressional authorization or oversight. Of the $16.65 billion in Bank of America's announced settlement figure, $7 billion is allocated to "consumer relief" — "credits" that the bank earns for spending money as the Justice Department sees fit, under the direction of a department-appointed "independent monitor."

The consumer relief under Bank of America's settlement agreement includes credits for the bank's forgiving principal on non-performing (past due and near default) loans or performing loans (including home equity lines and other second mortgages); for giving money to various administration-favored nonprofit groups (including housing and other community-activist and legal-aid organizations); and for funding "affordable" housing developments for low-income families. The debt write-off credits are capped at $2.15 billion for nonperforming loans and $3 billion for performing and home equity loans, with "extra credit" incentives encouraging the bank to focus its relief on "hardest-hit areas."

Whether banks should be writing off billions of dollars of loans at the government's behest is a debatable policy question — but one that would seem to fall within Congress' authority, not lie within the discretion of Justice Department lawyers. These write-off programs are decidedly not restitution to victims of the alleged conduct with which the government was accusing Bank of America; the conduct underlying this settlement involved the selling packages of securities bundling various mortgages to sophisticated institutional investors, not misleading individuals who bit off more than they could chew in taking out a home mortgage.

Since mortgage write-downs are capped, where does the rest of the consumer-relief money go under the agreement? A minimum of $100 million must flow to various nonprofit housing and community groups, including community development funds or institutions, legal-aid groups fighting foreclosures, and various housing-activist groups. The agreement is structured to give Bank of America extra incentive to allocate more than the $100 million minimum to these groups, as it gets $2 in credits against its $7 billion consumer-relief settlement balance for each dollar it pays out to these organizations. Again, it's hard to see what these payments have to do with misleading institutional investors about the risk profile of mortgage-backed securities — or why these funding decisions should be made by the Justice Department rather than Congress.

Finally, the largest incentives in the Bank of America settlement encourage the bank to give to "affordable" family housing developments, with a whopping $3.25 credit against the $7 billion kitty for each dollar spent ($3.75 for "critical needs" family housing developments), and a $100 million minimum allocation. Essentially, this seems to us little more than housing policy by fiat — an expansion of the low-income housing tax credit without congressional authorization.

REGULATION THROUGH PROSECUTION

Many federal settlements, especially DPAs and NPAs and others that involve potential criminal sanctions, go far beyond Bank of America's in asking businesses to make material changes to their operations, aside from cash payouts. The terms of such agreements do not merely require that the companies correct the specific practices alleged to be violations of the law, but rather call for major changes in firms' internal processes based on the apparent assumption that absent such changes, wrongdoing will be more likely to recur.

Such settlements have required companies to establish training and reporting programs; change compensation schemes; modify sales and marketing plans; hire new, senior "compliance officers," as well as independent "monitors" reporting to the prosecutor; and even to fire key personnel, including directors or chief executives.

Consider the 2013 DPA entered into with the Royal Bank of Scotland to resolve claims that the bank manipulated the London Interbank Offer Rate, a benchmark interest rate in many contracts worldwide. Notwithstanding that the alleged misconduct involved the foreign activities of a bank 82 percent owned by the British government, American prosecutors assumed the authority to pre-clear the bank's future public statements and to oversee its future interest rate submissions.

Whether banks should be writing off billions of dollars of loans at the government's behest is a debatable policy question, but one that would seem to fall within Congress' authority.

Time will tell the impact of U.S. government prosecutors' assuming supervisory review of a key benchmark embedded in contracts around the globe, but in other cases, the economic impacts of government settlements have already been vast. A 2012 DPA between the Justice Department and the foreign bank HSBC, foisted upon the bank facing the loss of its U.S. license, pushed the lender to abandon an array of business activities in parts of Asia and Latin America, thus depriving developing economies of critical access to capital.

In a closer-to-home example, prosecutors — including prominently New York's then-attorney general Eliot Spitzer — pushed the board of directors of AIG to sack longtime chief executive Hank Greenberg for the insurer's alleged improprieties. In the seven months after Greenberg departed, the insurer's financial products group wrote as many credit default swaps as it had in the prior *seven years* — a significant contributing factor in AIG's ultimate fall into federal receivership during the 2008 financial crisis.

Even when government attorneys are not pushing companies to jettison business lines or executives, they regularly insist on "independent monitors," reporting to the government but paid by the company, to oversee the business's operations. The government appointed a monitor in nine of 38 DPAs and NPAs it reached with companies in 2012 and nine of 28 in 2013.

Apart from the fact that it's a strange picture when the federal government is placing an individual in many of the largest American companies to look over executives' shoulders, the use of monitors allows the Justice Department broad discretion to reward allies with lucrative positions. In the Citigroup settlement parallel to Bank of America's, the monitor charged with overseeing the bank's $2.5 billion consumer-relief fund was Thomas J. Perrelli, Attorney General Eric Holder's former associate. Perrelli may or may not be the most qualified candidate for such a role, but his appointment, without transparency or congressional oversight, at least smacks of potential cronyism.

A WAY FORWARD

Identifying the problems with the shadow regulatory state is easier than formulating solutions. Prosecutorial discretion is inherent in the job, and no one would be well-served — least of all companies and their shareholders — by forcing the Justice Department to take every case to trial.

Still, Congress would be well-served to consider reducing some of the collateral consequences of corporate criminal convictions that all but eliminate businesses' ability to negotiate with government, to insist on greater transparency and judicial oversight of the settlement process, and to prevent prosecutorial settlements from effectively appropriating funds without going through Congress.

At least for Justice Department investigations with potential criminal convictions — which may not apply to civil settlements like Bank of America's — many large companies are all but unable to push back against prosecutors threatening them with debarment from government contracts, exclusion from government reimbursement, or loss of a banking or trading license.

Such provisions make sense in individual criminal prosecutions. For instance, there's a strong reason to punish individuals convicted of insider trading or market manipulation from serving as Wall Street traders. But should entire companies lose their business as a result of the actions of a rogue employee, often without the knowledge of or against the express orders of senior management? Would Congress really want seniors to be unable to get an essential drug reimbursed through Medicare, not because of concerns about safety or efficacy but because the manufacturing company's sales representative told doctors about a legitimate but "off-label" use for a different pharmaceutical product?

In addition to ending what is a virtual corporate death sentence looming over many corporate criminal investigations, Congress should take steps to insist that corporate settlement agreements with the Justice Department are transparent, are overseen by judges, and do not usurp the legislature's regulatory and appropriations powers. Non-prosecution agreements do not have to go before a judge at all, and deferred prosecution agreements are typically rubber-stamped.

The government almost always drafts DPAs and NPAs such that prosecutors have the sole discretion to determine whether the company has breached the agreement — which companies can ill afford to challenge, even when the government is applying vague or ambiguous compliance terms like "rigorous," "appropriate" or "adequate."

In reviewing a 2012 DPA entered into by the government and HSBC, U.S. District Judge John Gleeson of the Eastern District of New York took the unusual step of asking the parties to submit arguments articulating the proper role of the court in reviewing the agreement. The government argued that the judge's sole authority was to grant a delay to exclude the Speedy Trial Act requirement that the trial must start within 70 days after the date that prosecutors bring charges. (HSBC, anxious to move forward and get its settlement approved, agreed with this argument — as would most companies in similar individual cases.) The judge disagreed, but he let the agreement stand — and there's little way of knowing whether other judges and appellate courts would accept the Justice Department's view of the judiciary's cabined role. *United States v. HSBC Bank USA*, No. 12-CR-763, slip op. at 2 (E.D. N.Y. July 1, 2013).

OPTIONS FOR REFORM

In looking for a template for reform, Congress would be well-served to look across the Atlantic to the United Kingdom, where just last year, Parliament passed the Crime and Courts Act, which introduced DPAs to the British criminal justice system, beginning in February 2014.

The new U.K. rules ensure that judges must oversee every step of the DPA process and make findings in open court according to predetermined legal norms. The court must be involved in supervising the selection of any corporate monitor and approve a detailed work plan for the corporate monitor's responsibilities, and the court must approve any subsequent modifications to the DPA or any finding of breach by applying a two-step legal test in a public decision.

In terms of sanctions, the U.K.'s new DPA law expressly ties monetary penalties to the fine that a court would levy on the company if it pleaded guilty to the offense.

Although it is too soon to tell how the new British DPA system will work in practice, on its face it mandates a transparency, structure and judicial oversight typically absent in American practice. Such features are salutary. Prosecuting business frauds is an important government role, but our current corporate settlement practice is severely lacking. Giving prosecutors the authority to serve as judge, jury and regulator with near-unfettered discretion erodes the rule of law, oversteps congressional authority, and vests in attorneys who often lack any business experience or economic expertise vast regulatory authority, not subject to review, and with the potential to cause sweeping economic consequences. WJ

Ontario Court of Appeal limits securities class actions

By Andrew Gray, Esq., and Rebecca Wise, Esq.
Torys LLP

The Court of Appeal for Ontario has recently released its decision in *Peter Kaynes v. BP PLC*, 2014 ONCA 580, ruling Ontario was not the appropriate jurisdiction for a secondary market securities class action for investors who purchased their securities outside Canada. The Court of Appeal applied the principle that securities litigation should take place in the jurisdiction where the investor's securities transaction occurred.

The decision in *BP* aligns the approaches of Ontario and U.S. law to the jurisdictional scope of securities class actions. It should lead Ontario courts in future cases to limit the scope of secondary market misrepresentation class actions to investors who acquired their securities on a Canadian stock exchange.

THE PROPOSED CLASS ACTION AND JURISDICTIONAL CHALLENGE

In the BP securities litigation, it is alleged that the company's continuous disclosure contained misrepresentations about the impact of the Deepwater Horizon accident. Proposed secondary market misrepresentation class actions were subsequently commenced in the U.S. and Ontario. In the Ontario action, the plaintiff intended to seek orders both certifying a class action and granting leave to assert the statutory cause of action for secondary market misrepresentations created by Ontario's Securities Act.

The plaintiff in the Ontario case acquired his BP securities on the New York Stock Exchange, but he is a Canadian resident. The proposed class in the Ontario litigation included all residents of Canada who acquired BP securities during the class period, wherever those securities were purchased.

BP challenged the jurisdiction of the Ontario court and also argued, alternatively, that the Ontario court should decline jurisdiction over the proposed class action. The Court of Appeal found that while Ontario had jurisdiction, it should decline jurisdiction on the basis of *forum non conveniens*. The action was therefore stayed, with leave to the plaintiff to reconfigure the case in a manner that restricted it to investors who acquired BP securities on the Toronto Stock Exchange.

The Court of Appeal held that asserting jurisdiction over the claim would be inconsistent with the international context of the securities law regimes in the U.S. and the U.K., where the majority of BP's securities traded. By statute, both the U.S. and U.K. regimes assert jurisdiction in secondary market misrepresentation cases on the basis of the location of the exchange where the securities are traded. Further, U.S. courts have exclusive jurisdiction over claims based on secondary market misrepresentations under U.S. securities laws and no jurisdiction over claims relating to transactions that occurred in foreign jurisdictions.

Andrew Gray (L) practices at **Torys LLP** in Ontario, focusing on civil litigation in a range of areas, including corporate/commercial, securities and insolvency matters. He has worked on contested transactions, securities litigation, Ontario Securities Commission investigations, Companies' Creditors Arrangement Act proceedings and plans of arrangement. **Rebecca Wise** (R) practices civil litigation in a variety of areas, including securities, corporate/commercial, class actions and employment law.

Having regard to comity, the Court of Appeal held that order and fairness are achieved by adhering to the prevailing international standard, which ties jurisdiction to the place where the securities were traded. Declining jurisdiction on the basis that an investor's transaction did not take place on a Canadian exchange aligns the approach in Ontario to the approach taken in the U.S. It also helps to create an orderly and predictable regime for the resolution of claims in securities markets consistent with investors' expectations.

As the Court of Appeal stated, "[i]t would surely come as no surprise to purchasers who used foreign exchanges that they should look to the foreign court to litigate their claims."

IMPLICATIONS OF THE DECISION

The securities of Canadian companies are often listed on both a Canadian stock exchange and a U.S. stock exchange. In the context of shareholder class actions, this can result in a multiplicity of proceedings.

For cases where, as in *BP*, the securities at issue do not trade on a Canadian exchange, it will not be appropriate for an Ontario court to assert jurisdiction. Consistent with this approach to jurisdiction, the *BP* decision should also limit the scope of classes an Ontario court will certify in secondary market misrepresentation cases.

The principle animating the jurisdiction decision in *BP* is that investors should expect misrepresentation claims to be adjudicated in the place where they acquired their securities and under the law of that jurisdiction. It would, therefore, be inappropriate for an Ontario court to certify a class that includes investors who acquired securities on a foreign stock exchange, or outside of Canada. Secondary market misrepresentation class actions in Ontario should be available only to investors who acquired their securities on a Canadian stock exchange. WJ

LifeLock seeks dismissal of securities fraud claims

By Phyllis Lipka Skupien, Esq., Managing Editor, Westlaw Journal

Identity theft protection provider LifeLock Inc. has asked a federal court to dismiss a securities fraud suit against it, arguing there is no basis for allegations that it misled investors about its operations or a Federal Trade Commission investigation.

In re LifeLock Inc. Securities Litigation, No. 14-416, motion to dismiss filed (D. Ariz. Sept. 15, 2014).

The motion to dismiss, filed in the U.S. District Court for the District of Arizona, says the investor plaintiffs are only complaining about purported mismanagement due to its growing pains.

"Plaintiff's allegations show, at best, a booming company's growing pains — as expressly disclosed in LifeLock's SEC filings — not a fraudulent plot to conceal bad news from investors," the motion says.

FTC INVESTIGATION

Founded in 2005, LifeLock was accused of using questionable advertising practices that resulted in the FTC filing a complaint in 2010.

According to the shareholder suit, the agency alleged LifeLock misled consumers about the extent of the protection its services provided and the guarantees it offered.

The FTC and LifeLock subsequently entered into a "deceptive advertising practices" settlement that included companion orders with 35 state attorneys general in March 2010 and required the company to pay them a total of $35 million, according to the complaint.

According to the plaintiffs, however, the company continued its deceptive advertising practices and met with FTC regulators in February this year about its alleged noncompliance (based on a whistleblower report).

The suit alleges LifeLock continued to misrepresent the effectiveness and scope of its credit-monitoring services in violation of the FTC order.

On news of the reopening of the FTC investigation, the price of LifeLock shares fell from $21.79 to $20.32, or more than 6 percent, on Feb. 24, the suit says.

The suit alleges LifeLock violated the anti-fraud provisions of federal securities laws in Sections 10(b) and 20(a) of the Securities Exchange Act, 15 U.S.C. §§ 78j(b) and 78t(a).

MOTION TO DISMISS

LifeLock contends in its motion to dismiss that plaintiffs' allegations do not meet the standards for securities fraud claims as they did not sufficiently allege *scienter*, or intent to deceive. The company also says its statements did not cause investor losses.

LifeLock maintains it expressly informed shareholders that its growth had strained its operational ability and management resources. According to the amended complaint, part of the dispute concerns whether its customer alerts were delayed or disabled to handle its growing customer base.

The company notes that revenue grew from $18.9 million in 2007 to $369.7 million in 2013.

LifeLock says the 2010 FTC order enjoined the company from making any misrepresentations regarding its identify-theft-protection services and it has since adopted new technology and brought in new directors and management.

As a result, LifeLock maintains, it has not deceived consumers or investors.

The suit should be dismissed, LifeLock says, because the company made the requisite disclosures to shareholders regarding the FTC order and follow-up, and the plaintiffs have made only conclusory allegations regarding its operations.

"[The company's] blunt, timely disclosures undermine any inference of intentional or reckless concealment of adverse information," LifeLock asserts. WJ

Attorneys:
Defendant: Cynthia A. Ricketts and Katherine L. Pappas-Benveniste, Sacks, Ricketts & Case, Phoenix; Boris Feldman, Elizabeth C. Peterson, Gideon A. Schor and Brian Danitz, Wilson Sonsini Goodrich & Rosati, Palo Alto, Calif.

Related Court Document:
Motion to dismiss: 2014 WL 4760621

See Document Section A (P. 21) for the motion to dismiss.

Courtesy of www.lifelock.com

The suit alleges LifeLock continued to misrepresent the effectiveness and scope of its credit-monitoring services in violation of a Federal Trade Commission order   A screenshot of LifeLock's website is shown here.

Pest management company deceived investors about prospects, suit says

A shareholder of Marrone Bio Innovations has filed a lawsuit accusing the bio-based pest control company of misleading investors about the efficacy of its products and projected sales, both before and after its $57 million initial public offering.

Oldham v. Marrone Bio Innovations Inc. et al., No. 14-2130, complaint filed (E.D. Cal. Sept. 15, 2014).

During the IPO in August 2013, Marrone sold about 4.75 million shares of its stock at $12 per share, plaintiff Kent Oldham says in the proposed class-action complaint, filed in the U.S. District Court for the Eastern District of California.

The suit alleges Marrone made numerous misleading statements in its registration statement and prospectus about the efficacy of products. The offering documents also contained revenue and sales projections the company knew it had "no reasonable expectation of meeting," the complaint says.

Simultaneously, the company said its financial statements for the quarters ending March 31 and June 30 could not be relied upon.

On this news, the stock price fell from $5.65 on Sept. 2 to $3.15 on Sept. 3.

The plaintiff says that in less than three days Marrone securities lost half their value — representing $68 million in losses to investors — and that the stock price had been artificially inflated as a result of the company's misrepresentations.

Also named as defendants in the suit are company CEO Pamela G. Marrone, former CFO Glidewell and CFO James B. Boyd, as well as its board members and underwriters. Absi is not a defendant.

The offering documents contained revenue and sales projections the company knew it had "no reasonable expectation of meeting," the complaint says.

Marrone did not return a request for comment on the allegations.

The suit claims that insiders cashed in their personal stock holdings as soon as possible before the fraud was revealed.

The insiders were prevented from selling their stock for 180 days following the IPO, or until Jan. 29, the suit says. On that day then-CFO Donald J. Glidewell sold the majority of his options and holdings, and then-COO Hector Absi sold every option he owned, the suit says.

Both officials have since resigned from the company, according to the complaint.

Marrone announced Sept. 3 that its board's audit committee had begun an internal investigation of a questionable $870,000 transaction that had been included in the financial statements for the 2013 fourth quarter.

The defendant underwriters are Piper Jaffray & Co., Jefferies LLC, Stifel Nicolaus & Co. and Roth Capital Partners.

Oldham says the defendants violated Sections 11 and 12 of the Securities Act, 15 U.S.C. § 77k, and Sections 10(b) and 20(a) of the Securities Exchange Act, 15 U.S.C. § 78j(b).

He seeks compensatory damages, attorney fees and costs.

The proposed class period is from the date of the company's IPO on Aug. 2, 2013, until Sept. 2, 2014. WJ

Attorneys:
Plaintiff: Robert S. Green, James R. Noblin and Lesley E. Weaver, Green & Noblin, Larkspur, Calif.; Jeffrey C. Block, Jason M. Leviton and Steven P. Harte, Block & Leviton, Boston

Related Court Document:
Complaint: 2014 WL 4624886

$362 million MBS suit in limbo against Citigroup

A New York judge has deferred ruling on whether to throw out a German bank's lawsuit accusing Citigroup of misrepresenting mortgage-backed securities until he determines the correct application of a German statute of limitations.

Deutsche Zentral-Genossenschaftsbank AG et al. v. Citigroup Inc. et al., No. 654566/2012, 2014 WL 4435991 (N.Y. Sup. Ct., N.Y. County Sept. 8, 2014).

Justice Charles E. Ramos of the New York County Supreme Court will hold Citigroup's motion to dismiss DZ Bank's suit in "abeyance" until he holds a hearing on the limitations period.

After determining that the German statute of limitations for fraud claims applies because DZ is based in Germany and because New York law "borrows" the shortest available limitations period, Justice Ramos said a hearing with expert testimony on German law is required.

The German three-year limitations period begins to run when a plaintiff has "sufficient knowledge" of a claim but DZ Bank and Citigroup disagree on a plaintiff's statutory obligation to investigate claims, according to Justice Ramos' opinion.

REUTERS/Ralph Orlowski

Plaintiff DZ Bank, whose headquarters in Frankfurt are shown here, says Citigroup misrepresented the risks associated with $362 million in mortgage-backed securities that it sold DZ between 2005 and 2007.

> The judge said the German three-year limitations period applies because plaintiff DZ Bank is incorporated in Germany and a New York branch of the bank is not a separate entity.

DZ Bank filed its summons with notice Dec. 28, 2012, starting the litigation under New York law.

Applying the German limitations period, Citigroup can have the suit dismissed if it can show that DZ knew about the alleged fraud or could have discovered it absent gross negligence before December 2009, the opinion says.

THE SECURITIES

The complaint accuses Citigroup of misrepresenting the risks associated with 17 mortgage-backed securities — mortgage loans bundled into large financial instruments — worth $362 million that it sold to DZ between 2005 and 2007.

According to the suit, Citigroup made false and misleading statements in the securities' offering materials regarding the quality of the underlying mortgage loans and their compliance with the bank's underwriting standards.

The securities fell drastically in value during the financial crisis and DZ filed suit. The complaint is seeking damages and rescission of the sales under claims of fraud, fraudulent concealment, negligent misrepresentation, and aiding and abetting fraud.

Citigroup moved to dismiss the suit as untimely under Germany's three-year limitations period. DZ argued that New York's six-year limitations period for fraud claims should apply because the damage occurred in New York to its New York branch.

Justice Ramos decided that the three-year period applies to the case because DZ is based and incorporated in Germany and a branch of a bank is not a separate entity.

BATTLE OF THE EXPERTS

Both parties presented the court with expert reports on how to apply Germany's limitations period but Justice Ramos ruled Sept. 8 that a hearing is necessary to determine when the statute is triggered.

DZ argues that it could not file the complaint until it had "sufficient knowledge" of its claims, while Citigroup maintains that DZ was grossly negligent in not discovering the alleged fraud before December 2009, the opinion says.

A date for the hearing has not yet been set. WJ

Attorneys:
Plaintiffs: Mark S. Arisohn, Labaton Sucharow LLP, New York

Defendants: Kevin P. O'Keefe, Bruce Birenboim and Susanna M. Buergel, Paul Weiss Rifkind Wharton & Garrison, New York

Related Court Document:
Opinion: 2014 WL 4435991

Shareholders may inspect McGraw-Hill's S&P records, N.Y. panel says

By Brett Goncher, Esq. Senior Content Writer, Westlaw Daily Briefing

McGraw-Hill Cos. shareholders may inspect the publisher's books and records to determine whether its directors mismanaged credit rating agency Standard & Poor's in the years leading to the 2008 financial crisis, a New York appeals panel has ruled.

Retirement Plan for General Employees of the City of North Miami Beach et al. v. McGraw-Hill Companies Inc., No. 12438, 2014 WL 4452678 (N.Y. App. Div., 1st Dep't Sept. 11, 2014).

In reversing a lower court's decision, the Appellate Division, 1st Department, panel unanimously ruled that McGraw-Hill Companies Inc. shareholders could enforce both statutory and common-law rights to inspect internal records concerning the management of subsidiary Standard & Poor's Financial Services LLC.

"Petitioners identified several reasons for making their demand, including assessment of policies that the board had implemented when issuing credit ratings and investigation of possible wrongdoing by the respondent's board of directors," the panel said.

"Each of these purposes adequately justifies petitioners' access to certain board documents," it said.

However, the panel remanded the case to the trial court to determine the scope of the shareholders' records inspection.

FRAUDULENT RATINGS

The dispute stems from S&P's alleged mid-2000s strategy to attract more business and revenue by giving undeserved high grades to complex mortgage-related investments, including mortgage-backed securities and collateralized debt obligations that the agency's clients want to sell.

According to the shareholders, without S&P's high ratings, the securities would have been unmarketable. The ratings were later revealed to be unjustified as many of the securities were subsequently downgraded to "junk" status, the shareholders say.

In November 2011, shareholder Retirement Plan for General Employees of the City of North Miami Beach sent a letter to McGraw-Hill demanding to inspect the board's books and records relating to its oversight and management of S&P.

Citing N.Y. Bus. Corp. Law § 624 and state common law, the pension fund stated that the demand's purpose was to investigate whether the board breached its fiduciary duties and to assess its policies regarding S&P's procedures in rating mortgage-related investments.

After McGraw-Hill refused to produce any documents not required by Section 624, the pension fund and another shareholder filed a petition in the New York County Supreme Court seeking records relating to the board's knowledge and oversight of S&P.

The petition cited a 2011 U.S. Senate subcommittee report concluding that various credit rating agencies helped cause the 2008 financial crisis by issuing investment-grade ratings for subprime mortgage securities despite knowing of increasing risks in the mortgage markets.

McGraw-Hill opposed the petition, arguing that the petitioners failed to show a "proper purpose" and that their demand was an overly broad "fishing expedition."

It also asserted that Section 624 permits shareholders to access only board minutes and accounting information.

Justice Jeffrey Oing rejected the petition in a 2013 bench ruling.

PROPER PURPOSE FOR INSPECTION

On appeal, the five-judge panel explained that Section 624 and state common law permits shareholders to inspect corporate books and records so long as they are acting in good faith and have a valid purpose.

"The statutory right supplemented, but did not replace, the common-law right," the panel said.

REUTERS/Brendan McDermid

The panel found that the petition's allegations formed a proper purpose, specifically that McGraw-Hill's directors had mismanaged S&P and breached their fiduciary duties in failing to oversee the agency's alleged wrongdoing, which exposed the publisher to potential liability in multiple civil lawsuits and investigations.

"Contrary to respondent's contentions, investigating alleged misconduct by management and obtaining information that may aid legitimate litigation are, in fact, proper purposes for a Section 624 request, even if the inspection ultimately establishes that the board engaged in no wrongdoing," the panel said.

It concluded that a hearing will be necessary on remand to determine which records are relevant and necessary for the petitioners' purposes. WJ

Attorneys:

For appellants: Robert M. Roseman, Wolf Popper LLP, New York

For respondent: Brian T. Markley, Cahill Gordon & Reindel, New York

Related Court Document:

Opinion: 2014 WL 4452678

Delaware-chartered firms can force investor suits into home-state courts

The directors of Delaware-chartered First Citizens BancShares did not violate that state's law by unilaterally adopting a bylaw that herds most investor suits into courts in North Carolina, where the bank is based, the Delaware Chancery Court's chief judge has ruled.

City of Providence v. First Citizens BancShares Inc. et al., No. 9795, 2014 WL 4409816 (Del. Ch. Sept. 8, 2014).

In a Sept. 8 opinion, Chancellor Andre G. Bouchard said even though his predecessor, Leo Strine Jr., previously ruled Delaware companies could adopt bylaws requiring shareholders to sue in the First State, that did not prevent First Citizens from choosing its home-state courts as its preferred venue. *Boilermakers Local 154 Ret. Fund et al. v. Chevron Corp. et al.*, No. 7220; *IClub Inv. P'ship v. FedEx Corp. et al.*, No. 7238, 73 A.3d 934 (Del. Ch. June 25, 2013).

Chancellor Bouchard's decision comes in a closely watched shareholder challenge to a bylaw that dissident First Citizens investors said was hurriedly adopted to give management the home-field advantage in a dispute over the bank holding company's controlling family's bid to buy a subsidiary in a "sweetheart" deal.

'INTELLECTUALLY CONSISTENT'

Some corporate law specialists had wondered whether Delaware's judges would tend to expand on the *Chevron* decision to try to effectively funnel all shareholder suits into the Chancery Court whenever the defendant corporation was incorporated in Delaware, as are most of the nation's Fortune 500 companies.

But attorney **Francis G.X. Pileggi**, who heads the Wilmington, Del., office of **Eckert Seamans** and hosts the Delaware Corporate & Commercial Litigation blog, said, as he expected, the ruling logically addresses a variation of the forum-selection issue.

"It is intellectually consistent with the reasoning of the prior Delaware decision that upheld a forum-selection clause in bylaws, to enforce such a clause that requires suit to be filed where the headquarters of a company is, as compared to its state of incorporation," he said.

The opinion is in keeping with a long line of Delaware rulings that give directors latitude to make reasonable decisions as to what's best for their companies, according to Pileggi, who was not involved in the case.

However, professor **Lawrence A. Hamermesh**, who heads the corporate law department at Widener University School of Law in Wilmington, said he's not sure that taking corporate governance cases back to the company's home state is, in effect "a good move."

"One of the better arguments for a presumption that courts of the state of incorporation will handle internal affairs disputes is that those courts are more experienced in the matter and are the ultimate source of definitive legal rulings," he said.

"That's not to say that courts of other states can't ever do a decent job, but a bylaw that systematically moves litigation from the courts of the state of incorporation to some other jurisdiction doesn't exactly advance the policy argument just noted," Hamermesh said.

A shareholder suit by the city of Providence, R.I., accused First Citizens' directors and officers of engineering their home-state-only bylaw to fend off in any shareholder challenge of the controlling family's planned $600 million purchase of the company's South Carolina-based affiliate, which the family also controls.

First Citizens is controlled by the Holding family through the Holding Group, which owns 52 percent of the bank's shares. It operates multiple banks providing consumer, business and commercial services through subsidiaries in 17 states.

After the merger, it reportedly will be the largest family-controlled bank in the nation, with more than 575 branches in 18 states and the District of Columbia.

The plaintiff said First Citizens insiders would profit at the expense of the shareholders if the company paid too much for a subsidiary.

DELAWARE IS JUST AN OPTION

Opposing First Citizens' motion to dismiss, the plaintiff said the company purposely incorporated in Delaware to avail itself of the state's corporate law, but its new bylaw bars shareholders from seeking review of the merger in the Chancery Court.

First Citizens asked the court to dismiss the suit on the ground that the Chancery Court has already endorsed forum-selection bylaws in *Chevron*.

But the plaintiff said only Delaware-court selection for Delaware-chartered companies has been endorsed, and First Citizens' bylaw essentially stands the *Chevron* decision on its head.

In his ruling granting First Citizens' motion to dismiss, Chancellor Bouchard said the plaintiff failed to show that the bank's bylaw is invalid or a breach of the directors' duty.

He said Delaware's corporate law "does not express any preference … one way or the other on whether it is permissible for boards of directors to require stockholders to litigate intra-corporate disputes in the courts of foreign jurisdictions."

Chancellor Bouchard said it was not unreasonable for the First Citizens directors to choose North Carolina's courts as their preferred venue — even though the *Chevron* decision gave them the option of choosing Delaware.

Moreover, he found it "immaterial" that the directors adopted their bylaw on a "cloudy" day — when dark clouds of shareholder discontent loomed on the horizon — and that the shareholders were powerless to repeal the bylaw due to the controlling family. WJ

Attorneys:
Plaintiff: Christine S. Azar and Ned. C. Weinberger, Labaton Sucharow LLP, Wilmington, Del.

Defendants: Gregory P. Williams, John D. Hendershot and Christopher H. Lyons, Richards, Layton & Finger, Wilmington

Related Court Document:
Opinion: 2014 WL 4409816

NEWS IN BRIEF

SEC ANNOUNCES LARGEST-EVER WHISTLEBLOWER AWARD

The Securities and Exchange Commission announced Sept. 22 that it expects to award a whistleblower more than $30 million for providing key original information that led to a successful SEC enforcement action. The award was the fourth given to a whistleblower living in a foreign country, demonstrating the program's international reach, the agency said. The program rewards high-quality information that results in an enforcement action with sanctions over $1 million and the awards can range from 10 percent to 30 percent of the money collected in a case. The agency noted that the whistleblower awards come from an investor protection fund established by Congress and are not taken from investors who have already been harmed. By law, the agency protects the identity of whistleblowers so no further information was provided.

S&P SHAREHOLDER ASKS APPEALS COURT TO REHEAR ARGUMENT

A Standard & Poor's shareholder is asking the 2nd U.S. Circuit Court of Appeals to rehear as a full panel its argument that it should be permitted to file a third amended ratings-fraud complaint against the ratings agency in light of new facts disclosed by the U.S. Department of Justice. A New York federal judge dismissed the suit by the Boca Raton Firefighters and Police Pension Fund for failure to prove fraud, and a 2nd Circuit panel affirmed that ruling in 2012. The pension fund says the new facts allegedly show that S&P misled investors. However, the trial court denied the pension fund's motion to rehear the case and the 2nd Circuit affirmed Sept. 8. The fund says in its Sept. 19 petition for full-court rehearing that a complaint filed last year in California federal court by the Justice Department shows specific misrepresentations S&P made regarding its credit ratings business.

Boca Raton Firefighters and Police Pension Fund v. McGraw-Hill Cos. et al., No. 13-4039, petition for reh'g en banc filed (2d Cir. Sept. 19, 2014).

SEC HITS HIGH-FREQUENCY TRADING FIRM WITH RECORD $16 MILLION FINE

High-frequency trading firm Latour Trading LLC has agreed to pay $16 million in the largest fine imposed for violating the Securities and Exchange Commission's net capital rule, the agency announced Sept. 17. The rule requires broker-dealers, like Latour, to maintain certain levels of net capital to support their trading. High-frequency traders use advanced computer systems with proprietary algorithms to make rapid trades that take advantage of price inequalities in markets. According to the SEC, Latour did not have the necessary capital on 19 of 24 reporting dates between 2010 and 2011. The firm missed the mark by levels ranging from $2 million to $28 million, the SEC said. Former Latour chief operating officer Nicolas Niquet also agreed to pay a $150,000 penalty to settle related SEC charges. The defendants did not admit or deny any wrongdoing.

In the Matter of Latour Trading LLC et al., No. 3-16128, order instituting administrative and cease-and-desist proceedings issued (S.E.C. Sept. 17, 2014).

Chinese labor shortage

CONTINUED FROM PAGE 1

The complaint named as defendants Texas-based Diodes, CEO Keh-Shew Lu and CFO Richard White.

Diodes manufactures and sells semiconductors that are incorporated into a variety of computing, communications and automotive products, the suit said. The company's headquarters are in Plano, but its primary manufacturing facility is located in Shanghai.

UNDISCLOSED LABOR PROBLEMS

According to the suit, the defendants made public statements in February and May 2011 that hid the fact that Diodes' labor problems at its Shanghai plant were more "profound and protracted" than disclosed, leading to an artificially inflated share price.

This allowed company insiders, including Lu and White, to cash out for combined profits of almost $14 million before the truth emerged, the pension fund said.

Diodes allegedly revealed the truth on June 9, 2011, when it revised its financial projections. The market reacted harshly and the company's share price fell by almost 14 percent the next day, the suit said.

The complaint alleged violations of the anti-fraud and control-person provisions of the Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78j(b) and 78t(a).

CONFIDENTIAL WITNESSES

In a Sept. 16 memo supporting dismissal, the defendants said the complaint failed to meet the heightened pleading standards of the Private Securities Litigation Reform Act of 1995, 15 U.S.C.A. § 78u-4.

Among other deficiencies, the complaint neglected to provide sufficient information about the nine confidential witnesses it relied on, they said.

Judge Schneider largely agreed, noting that the allegations of fraudulent intent, or *scienter*, were founded "almost entirely" on confidential witness statements.

With most of its confidential witness statements disregarded, the plaintiff was left with insufficient allegations that the defendants knew, or were reckless in not knowing, about the misleading nature of their statements, the judge said.

As to claims the defendants failed to disclose the cause of the labor shortage and Diodes' inability to cope with it in their February 2011 statements, the complaint pleaded only that the defendant "must have known," an approach that has been "squarely rejected" in appeals court decisions, he said.

> The witnesses' statements cannot support a finding of *scienter* related to "crucial allegations linking key executives to on-the-ground decision-making," the judge wrote.

Eight of the nine confidential witnesses are described only by their job titles, without information about their duties or the circumstances through which they acquired the relevant information, the judge said.

The witnesses' statements cannot support a finding of *scienter* related to "crucial allegations linking key executives to on-the-ground decision-making," he said.

HEART OF THE DISPUTE

The heart of the dispute is whether the complaint adequately alleges *scienter*, Judge Schneider said.

The plaintiff's *scienter* allegations regarding the defendants' May 2011 statements are a "closer question," but they still failed to raise a compelling inference of knowledge, Judge Schneider said.

The complaint's allegation of suspicious stock sales by insiders also failed to support a finding of *scienter* because relevant information about the sales was missing, the judge said, noting that most of the sales did not take place during an "advantageous time period." WJ

Related Court Document:
Opinion: 2014 WL 4635586

CASE AND DOCUMENT INDEX