Securities Regulation Daily Wrap Up, TOP STORY—N.D. Cal.: Wells Fargo D&Os must defend claims over bogus accounts, (Oct. 5, 2017)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Anne Sherry, J.D.

The vast majority of a derivative action stemming from Wells Fargo's "eight is great" account-creation scheme cleared a significant procedural hurdle. Finding it "implausible" that Wells Fargo's officers and directors were unaware that false accounts were being created to bolster the bank's cross-selling metrics, the district court in the Northern District of California denied their motion to dismiss as to most of the plaintiffs' fraud and fiduciary duty claims (*In re Wells Fargo & Company Shareholder Derivative Litigation*, October 4, 2017, Tigar, J.).

The plaintiffs' claims are rooted in a litany of quarterly and annual filings between 2011 and 2016. The complaint also alleges that each of the director defendants led or participated in a board committee responsible for oversight of the allegedly fraudulent banking practices. The consolidated complaint alleges breach of fiduciary duty; unjust enrichment; violations of Exchange Act Sections 14(a), 10(b), 20A, and 29(b) and their corresponding rules; violations of the California Corporations Code; corporate waste; and contribution and indemnification. The court dismissed without prejudice the 10(b) claims against one director defendant and the indemnification and contribution claims, and dismissed the claims against four defendants under California Corporations Code Section 25402. The remaining claims survived.

Falsity. Notably, the fraud claims under the Exchange Act cleared the bar for falsity and scienter. The director defendants argued that the complaint referred generally to "Defendants," without matching specific actions to specific defendants. But the court rejected the idea that the complaint engaged in shotgun pleading—it identified the allegedly misleading statements in Wells Fargo's SEC filings and included a table showing which defendants signed which filings. The court also rejected the argument that the claims should be dismissed for engaging in group pleading. The plaintiffs did rely in part on the group pleading doctrine, but not exclusively. Their principal allegation, that the directors are liable because they "made" the false statements by signing the SEC filings, sufficed.

The complaint also adequately pleaded falsity as to the officer defendants. For example, Timothy Sloan, who succeeded John Stumpf as CEO, said in May 2014 that the "secret sauce" of the bank's success at cross-selling was the tenure of its employees. The plaintiffs plausibly alleged that this statement was false and misleading when made, given that the bank terminated thousands of employees involved in cross-selling. Carrie Tolstedt, Senior Executive Vice President of the Community Banking division, argued that her statements about cross-selling were puffery, but the plaintiffs' allegations about Tolstedt's position and oversight role within the division rendered those statements materially false or misleading in context.

Scienter. As to scienter, the court only had to examine the complaint's pleadings against the officer defendants because it determined in a prior order that the plaintiffs pleaded scienter as to the directors. In that order, the court noted a number of red flags that plausibly suggested that a majority of the directors knew about the account creation scheme by 2014. While not all of these red flags applied to the officers, it was equally, if not more, implausible that they remained unaware given their involvement in the bank's day-to-day operations and access to the underlying cross-sell metrics and employee whistleblower complaints.

Even if the plaintiffs failed to allege facts showing each officer had the requisite state of mind, the core operations doctrine supported a strong inference of scienter. One prong of this doctrine establishes that, where the relevant fact is so prominent that it would be absurd to suggest that management was unaware of the matter, allegations regarding management's role may be sufficient without the need for particularized allegations. "Given the 'prominence' of cross-selling in Wells Fargo's business, the close manner in which it was monitored, and the

red flags from the employee complaints, the *Los Angeles Times* article, and the investigations by regulatory agencies, 'it would be absurd to suggest that management was without knowledge of the matter,'" the court reasoned.

Proxies. The complaint also met the pleading threshold with respect to the Section 14(a) proxy claims. Although under Ninth Circuit law such claims may not be premised solely on alleged mismanagement or breach of fiduciary duty, the plaintiffs' claims were also based in fraud. Just as in *In re Countrywide* (C.D. Cal. 2008), the thrust of the complaint was that the defendants knew of, but failed to disclose, a fraudulent business practice that put the company at material risk. And just as in that case, the plaintiffs argued that shareholders would not have reelected the directors, approved compensation packages, or rejected an independent chairman. This is an actionable claim, its "allegations go far beyond mere puffery," and the plaintiffs sufficiently pleaded loss causation.

Other claims. The plaintiffs also seek rescission of the contracts between the defendants and Wells Fargo under Section 29(b); those claims will proceed. Certain defendants who sold shares back to Wells Fargo will face Section 20A claims alleging they knew those shares to be artificially inflated in price, although the insider trading claims under the California Corporations Code were dismissed as Wells Fargo is a Delaware corporation. The breach of fiduciary duty claims under Delaware law, however, adequately pleaded that the defendants were on notice of the fraud and took no action to remedy it.

The case is No. 16-cv-05541-JST.

Attorneys: Betsy Carol Manifold (Wolf Haldenstein Adler Freeman & Herz LLP) for Victoria Shaev. Brendan P. Cullen (Sullivan & Cromwell LLP) for Wells Fargo & Co. Emily Victoria Griffen (Shearman & Sterling) for John D. Baker, II.

Companies: Wells Fargo & Co.

MainStory: TopStory CorporateGovernance CorpGovNews GCNNews DirectorsOfficers ExecutiveCompensation FiduciaryDuties FraudManipulation Proxies PublicCompanyReportingDisclosure RiskManagement CaliforniaNews