

[Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—S.D. Cal.: Fraud claims against Bofl dismissed, \(Dec. 10, 2018\)](#)

Securities Regulation Daily Wrap Up

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By Rebecca Kahn, J.D.

For a second time, investors failed to adequately state a fraud claim against a bank and its executives. The Southern District of California previously granted investors leave to amend allegations that the bank had misrepresented whether federal regulators were investigating the bank for improper activity and whether the bank engaged in lending to criminals. This time, the court dismissed with prejudice, as the investors' second amended complaint failed to adequately plead loss causation (*Mandalevy v. Bofl Holding, Inc.*, December 7, 2018, Curiel, G.).

Investors claimed that Bank of Internet Holding, Inc., and certain of its executives violated Exchange Act Sections 10(b) and 20(a) by making public misrepresentations about government investigations of Bofl as well as alleged loans to criminals. The plaintiffs claimed that the false representations misled investors and, when media reports revealed the truth of these misrepresentations, Bofl's share price dropped.

Investigations. The SEC had opened an informal inquiry in 2015, then a formal investigation the following year during the course of which it subpoenaed Bofl. But Bofl did not disclose the existence of the subpoenas. The *New York Post* reported that the DOJ and Treasury were also investigating Bofl. The SEC ultimately determined not to recommend enforcement action against the bank.

Disposal of 2015 whistleblower action. Bofl's former internal auditor, Matt Erhart, allegedly uncovered widespread misconduct at Bofl and filed a whistleblower lawsuit in October 2015, claiming that Bofl had altered company financials, falsely responded to government subpoenas, and failed to disclose loans to criminals. On March 14, 2016, Bofl filed a Form 8-K disclosing that Dentons law firm had investigated and found "no support" for Erhart's allegations. Bofl stated in a press release on April 18, 2016: "The absence of public enforcement actions highlight how disconnected [Erhart's] allegations are from the reality of Bofl's highly compliant and top-performing business."

Prior dismissal. Investors filed a class action against the defendants in April 2017, asserting claims under Exchange Act Section 10(b) and Rule 10b-5 as well as Exchange Act Section 20(a) by making misrepresentations about Bofl's loans to criminals and government investigations. The court dismissed with leave to amend in June 2018. The dismissal order addressed the CEO's statement that Bofl had not received any material inquiry that would trigger a Form 8-K filing.

CEO's statement. The plaintiffs were required to plead with specificity the materiality of the investigation, as the falsity of the CEO's statement hinged on whether the investigation was material or not. The court found that the plaintiffs failed to explain why the SEC investigation was material. Further, they failed to explain any qualitative factors that would show materiality. Therefore, the plaintiffs failed to sufficiently demonstrate that the CEO's statement was misleading.

Not a material proceeding. The SEC's 16-month formal investigation was not a material proceeding requiring disclosure, the court ruled, because it is not a "pending legal proceeding" until it reaches a stage when the agency or prosecutorial authority makes known that it is contemplating filing suit or bringing charges. Since the plaintiffs failed to allege that the SEC had made it known that it was contemplating filing suit or bringing charges, they failed to adequately show that this was an actionable omission.

Loan to convicted criminal. On October 26, 2016, *Seeking Alpha* reported that Bofl had made indirect loans to Jason Galanis, a convicted criminal. On an earnings call the following day, the CEO denied that Bofl made any such loan.

Falsity. The court found that the plaintiffs adequately pleaded that it was false for Bofl to state, in an April 18, 2016, press release, that Erhart's allegations were disconnected from reality. Plaintiffs had also adequately demonstrated the falsity of the CEO's statement during the October 2016 earnings conference call denying that Bofl had any interest credit exposure ownership of any loan to Galanis. The complaint also demonstrated that it was false for Bofl to issue a press release on March 31, 2017, saying that it has received no indication of and has no knowledge regarding the money laundering investigation.

Loss causation. To plead loss causation, a plaintiff "must plausibly allege that the defendant's fraud was revealed to the market and caused the resulting losses." The court stated that any "corrective disclosure must be relevant to the alleged misrepresentation at issue; it must relate back to the misrepresentation and not to some other negative information about the company."

The court first considered the statement that Erhart's allegations were disconnected from reality. The plaintiffs claimed that this statement had been revealed to be false through a *Seeking Alpha* article. The court noted that the information relied upon by the article's author was already public and disagreed with the assertion that the author engaged in any specialized analysis. With respect to the October 27, 2016, denial of any loans to Galanis, the plaintiffs failed to allege a corrective disclosure that occurred after the statement was made. Finally, the court addressed the March 31, 2017 press release in which Bofl denied receiving any indication or having any knowledge of the money laundering investigation. Plaintiffs identified the corrective disclosure of this statement as an October 25, 2017, *New York Post* article stating that Bofl had been under SEC investigation. The court found that this article did not disclose any previously nonpublic information.

Loan to Galanis In an October 27, 2016, earnings conference call, the CEO denied that Bofl made any loan to Jason Galanis. Since there was no corrective disclosure of this statement issued after this earnings call, the plaintiffs failed to show loss causation for this statement.

The plaintiffs contended that the October 26, 2016, *Seeking Alpha* article disclosed "for the first time" that Erhart's allegations were true and that Bofl was making loans to criminals. The plaintiffs contended that the article provided a specialized analysis of facts not widely known to the market. The article explained that Bofl "funds an entity called ECC SPE that is tied to Emerald Creek Capital." Galanis took out a \$7 million loan from Emerald Creek, and then ECC SPE transferred the collateral behind the loan to Bofl. The court ruled that the plaintiffs had not sufficiently alleged this article was a corrective disclosure.

Money laundering investigation. In a March 31, 2017, press release, Bofl denied knowledge of any money laundering investigation. The plaintiffs claimed that two separate articles constituted corrective disclosures of this statement. First, the plaintiffs alleged that the April 6, 2017, *New York Post* article disclosed for the first time that the FDIC was involved in the money laundering investigation.

But the SAC did not allege that at the time Bofl issued its March 31, 2017, press release, the FDIC had launched a money laundering investigation into Bofl. Nor did the SAC allege that the April 6, 2017, *New York Post* article revealed that the FDIC had begun its investigation prior to March 31, 2017. Therefore, these were not corrective disclosures relating back to any misrepresentation.

As this was the third iteration of the plaintiffs' complaint, the court dismissed with prejudice.

The case is [No. 17-cv-667](#).

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Companies: Bofl Holding, Inc.

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