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Bulk of Wells Fargo Shareholder Derivative Suit Survives Motions to Dismiss

On October 4, 2017, in *In re Wells Fargo & Company Shareholder Derivative Litigation*, which concerns alleged sales practices at Wells Fargo that have received wide attention, Judge Jon S. Tigar of the Northern District of California substantially denied Defendant Officers and Directors' motions to dismiss the complaint.[1] Judge Tigar had previously granted in part and denied in part nominal Defendant Wells Fargo's motion to dismiss the complaint.[2] Notably, the Court's October 4th order took a somewhat broad read of the complaint's allegations concerning the directors' knowledge of the alleged sales practices that support Plaintiffs' Section 10(b) and Rule 10b-5 claims, as well as its claims under Section 14(a). While the Court's approach could influence how future courts evaluate the adequacy of Plaintiffs' pleading of such claims, the allegations with respect to Wells Fargo may be sufficiently unique that this opinion may well be limited to its unusual facts. Nevertheless, the opinion is a stark reminder to directors that they must be especially sensitive when allegations of misconduct on the part of management come to their attention, particularly when those allegations surface in multiple forms.

Background

Plaintiffs brought a shareholder derivative action against Wells Fargo & Company's officers, directors, and senior management, alleging that during the relevant period, the Director Defendants "knew or consciously disregarded that Wells Fargo employees were illicitly creating millions of deposit and credit card accounts for their customers, without those customers' knowledge or consent."[3] In particular, Plaintiffs allege that Wells Fargo, "under Defendants' watch, . . . defrauded their customers in an attempt to drive up "cross-selling," i.e., selling complimentary Wells Fargo banking products to prospective or existing customers."[4]

The complaint alleges that the Director Defendants knew about the alleged fraudulent activity because, among other things, they were aware of (1) letters explaining that the company's "Gr-Eight initiative" created a high-pressure sales culture fostering fraudulent practices; (2) complaints made through Wells Fargo's "EthicsLine"; (3) a whistleblower lawsuit by an employee related to the creation of fake accounts; (4) several wrongful termination and employment discrimination lawsuits; (5) investigations and inquiries by government agencies; and (6) a Los Angeles Times article that examined the fraudulent account creation scheme and the company's internal policies and pressure that allegedly fueled it.[5] Plaintiffs contend that Defendants prepared and signed onto public filings that allegedly contained false or misleading statements that, at least to some extent, derived from inaccurate cross-sell metrics.[6]

With respect to the Director Defendants, Plaintiffs allege that each of the Director Defendants led or participated in a board committee that was responsible for overseeing banking practices that Plaintiffs allege to be fraudulent.[7] They also allege more generally that the Director Defendants did not ensure compliance with applicable laws, facilitated the account creation scheme, and caused the company to issue allegedly false or misleading quarterly and annual reports or proxy statements.

Orders on the Motions to Dismiss

Significantly, before the Court issued its most recent order denying Officer and Director Defendants' motion to dismiss, it had already largely denied nominal Defendant Wells Fargo's[8] motion to dismiss the complaint on the basis that Plaintiffs failed to plead demand futility. In that Order, issued May 4, 2017 (the "Demand Futility Order"), the Court concluded that "[t]he extensive and detailed allegations in the complaint plausibly suggest that a majority of the Director Defendants" had "consciously disregarded an obligation to be reasonably informed about the business and its risk or consciously disregarded the duty to monitor and oversee the business" and highlighted particular "red flags" that "collectively . . . support[ed] an inference that a majority of the Director Defendants consciously disregarded their fiduciary duties despite knowledge regarding widespread illegal account-creation activities, and . . . that there is a substantial likelihood of director oversight liability."[9]

The Court reiterated its concern over the alleged web of "red flags" in its more recent order on the motion to dismiss. All Defendants moved to dismiss Plaintiffs' claims under Section 10(b) and Rule 10b-5, and the Director Defendants moved to dismiss Plaintiffs' claims for breach of fiduciary duty under Section 14(a).[10] The Court denied the motions with respect to these claims.[11]

The Court rejected the Director Defendants' argument that Plaintiffs failed adequately to plead the material misrepresentation or omission and scienter elements of their Section 10(b) and Rule 10b-5 claims.[12] The Court determined, in line with its Demand Futility Order, that the complaint plausibly alleged that the Director Defendants made material and misleading statements by participating in, and approving of, particular public filings, which, the Court held, were extensively detailed in the complaint.

The Court was unpersuaded by the Director Defendants' argument that Plaintiffs' complaint was a "shotgun pleading" that failed to delineate specific actions and impermissibly relied upon the "group pleading" doctrine.[13] In a little-noticed holding that may prove useful for defendants elsewhere, Judge Tigar concluded that although the Ninth Circuit had not expressly spoken to the question, he agreed with the weight of authority in the District Courts holding that "group pleading" is not sufficient to satisfy the PSLRA's stringent pleading requirements.

However, the Court concluded that Plaintiffs do not *exclusively* rely upon group pleading in their complaint. Instead, Plaintiffs rely upon the fact that each of the Director Defendants signed certain SEC filings that Plaintiffs allege contains material and misleading information, which the Court held was

sufficient and separate from the group pleading doctrine. While the Court acknowledged that this holding was in tension with those of other courts in the Northern District of California, it emphasized that directors' signatures "w[ould] be rendered meaningless" if the directors are not held accountable for false and misleading statements made in public filings that they had signed.[14] The Court also noted that Plaintiffs' allegations based upon Director signatures on public filings are bolstered by allegations that "each of the Director Defendants was part of a specific committee whose general responsibilities would have afforded members knowledge regarding the illicit account creation scheme, and knowledge that the statements in the public filings were false or misleading."[15]

With respect to the scienter element, the Court reiterated the conclusion reached in its Demand Futility Order that the Plaintiffs successfully pleaded facts giving rise to scienter for purposes of their 10(b) claims, and determined that Plaintiffs likewise adequately alleged scienter with regard to the Officer Defendants. Judge Tigar had previously held, in the Demand Futility Order, that a variety of events, including Congressional testimony, consumer lawsuits, news reports, and widespread termination, suggested that a majority of the Director Defendants knew about the alleged illegal activity. The Court concluded that "[w]hile it is true that not all of these red flags apply to the Officer Defendants, the Court's logic applies with equal – if not greater – force to those defendants" because "it is implausible that Wells Fargo's senior management, involved in the day-to-day operations of the bank and with greater access to the underlying cross-sell metrics and employee whistleblower complaints than independent board members, was unaware of the alleged fraud."[16]

The Court also declined to dismiss Plaintiffs' claims under Section 14(a).[17] The Director Defendants argued that Plaintiffs' Section 14(a) claim must be dismissed because (1) proxy claims alleging corporate mismanagement or breaches of fiduciary duty not involving self-dealing are not actionable, and (2) the complaint does not adequately plead loss causation. The Court rejected both challenges. First, the Court agreed with Plaintiffs that the Section 14(a) claim is based on fraud in addition to mismanagement and breach of fiduciary duty. It concluded that "the thrust of Plaintiffs' complaint is that Defendants knew of, but failed to disclose, a fraudulent business practice that put the company at material risk – namely, the fraudulent account-creation scheme" and that Plaintiffs have asserted an actionable Section 14(a) claim by alleging that had this information been disclosed, shareholders would not have voted to re-elect Board members, approve executive compensation packages, and reject an independent board chairman.[18] Second, the Court concluded that Plaintiffs adequately alleged loss causation by alleging, among other things, that they were harmed by excessive compensation packages provided to Defendants and that they suffered a loss as arising from their vote to re-elect Board members based on proxy statements that included allegedly false or misleading information.[19]

In denying most of Defendants' motions to dismiss, the Court allowed the bulk of Plaintiffs' claims to proceed.

Conclusion

Judge Tigar plainly applied a relatively deferential standard to the allegations asserted in the Wells Fargo complaint. It is particularly notable that he held the allegations passed muster in light of the demanding standard for director liability set forth in *In re Caremark Int'l Inc. Derivative Litig.*, which requires a "sustained or systematic failure of oversight," which Judge Tigar acknowledged was "quite high."[20] It is likewise notable, given that Wells Fargo's corporate charter included an exculpatory clause pursuant to Section 102(b)(7) of the Delaware General Corporation Law, exculpating its directors except in cases of a breach of the duty of loyalty, or conduct involving bad faith, intentional misconduct, or a knowing violation of law.

It was evidently critical to the Court's conclusion that plaintiffs alleged that the director defendants had personal awareness of various alleged red flags concerning Wells Fargo's sales practices, such that they knew or recklessly disregarded statements in those securities filings about the company's sales practices. The Court appears to have been heavily influenced by the number of alleged red flags, and the extent to which they involved direct communication to the Board – *i.e.*, letters to the Board from employees voicing concern; the results of calls to the company's Ethics hotline, again, reported to the Board; regulatory investigations of which the Board was aware; and lawsuits brought by current and former employees—all on the topic of alleged sales practice improprieties.

The opinion also focused extensively on the fact that the directors in question each served on committees of the board with some responsibility for oversight of the alleged sales practice issues that later came to light. Such assertions regarding alleged red flags may be difficult to assert in other cases. Indeed, it is the rare case where directors and officers have been held liable or made a material settlement payment, and those cases have typically involved extraordinary situations such as WorldCom and Enron.

This case nevertheless serves as a reminder to directors that where a board learns of repeated allegations of a particular kind of misconduct, a court may later look with disfavor upon the absence of a clear record of action on the part of directors, and conclude—at least on a motion to dismiss—that a director consciously disregarded his or her duties.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[1] *In re Wells Fargo & Co. Shareholder Derivative Litig.*, No. 16-5541, slip op. at 49 (N.D. Cal. Oct. 4, 2017).

[2] *In re Wells Fargo & Co. Shareholder Derivative Litig.*, No. 16-5541, slip op. at 37 (N.D. Cal. May 4, 2017).

[3] *In re Wells Fargo & Co. Shareholder Derivative Litig.*, No. 16-5541, slip op. at 2 (N.D. Cal. Oct. 4, 2017) (quoting Compl. ¶ 1).

[4] *Id.*

[5] *Id.* at 2–3.

[6] *Id.* at 3–4.

[7] Director Defendants led or participated in the following committees: (1) Audit and Examination; (2) Corporate Responsibility; (3) Governance and Nominating; (4) Human Resources; and (5) Risk. *See id.* at 7-9 (citing Compl. ¶¶ 102–10).

[8] The Individual Director Defendants joined Wells Fargo's motion. *See In re Wells Fargo & Co. Shareholder Derivative Litig.*, No. 16-5541, slip op. at 1 n.1 (N.D. Cal. May 4, 2017).

[9] *Id.* at 17, 24.

[10] All Defendants also moved to dismiss Plaintiffs' derivative claims under Section 29(b) and Section 20A. Officer Defendants also moved to dismiss Plaintiffs' claims for breach of fiduciary duty under Delaware law, insider trading under California Law, and claims for unjust enrichment, contribution and indemnification. *In re Wells Fargo & Co. Shareholder Derivative Litig.*, No. 16-5541, slip op. at 14 (N.D. Cal. Oct. 4, 2017).

[11] The Court dismissed without prejudice Plaintiffs' claims against Defendant Michael Loughlin under Section 10(b). *Id.* at 49.

[12] To establish a violation of Section 10(b), a plaintiff must plead: (1) a material misrepresentation or omission made by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation. *See Stoneridge Inv. Partners, LLC* v. *Scientific-Atlanta*, 552 U.S. 148, 157 (2008). Defendants challenged Plaintiffs' satisfaction of the first two elements. *In re Wells Fargo & Co. Shareholder Derivative Litig.*, No. 16-5541, slip op. at 15 (N.D. Cal. Oct. 4, 2017).

[13] *Id.* at 17–18.

[14] *Id.* at 19 n.5 (quoting *Howard* v. *Everex Sys., Inc.*, 228 F.3d 1057, 1061 (9th Cir. 2000)).

[15] *Id.* at 20.

[16] *Id.* at 26.

[17] The Court held in its Demand Futility Order that "[t]he Director Defendants . . . face a substantial likelihood of liability on Plaintiffs' claims under Section 14(a) of the Exchange Act and SEC Rule 14a-9." *In re Wells Fargo & Co. Shareholder Derivative Litig.*, No. 16-5541, slip op. at 27 (N.D. Cal. May 4, 2017).

[18] *In re Wells Fargo & Co. Shareholder Derivative Litig.*, No. 16-5541, slip op. at 31–32 (N.D. Cal. Oct. 4, 2017).

[19] *Id.* at 33-34.

[20] 698 A.2d 959, 971 (Del. Ch. 1996).