SEC v. Bank of America: Back to the Drawing Board

BY JEFFREY PLOTKIN & DOREEN KLEIN

In a scathing decision issued in September 2009, Judge Jed Rakoff of the U.S. District Court for the Southern District of New York rejected as unfair, unreasonable, and inadequate a proposed settlement between the Securities and Exchange Commission (SEC) and Bank of America Corporation, setting the case down for trial in February 2010.[1] The court's well-founded skepticism toward the SEC and its methods would find few dissenters these days. Notwithstanding the logic underlying Judge Rakoff's decision, however, and the ire that it barely keeps contained, it remains to be seen whether the decision will achieve a rational and just result. Whatever the outcome, it raises vital questions about how the SEC perceives its own mandate, for the aftermath of the Madoff debacle has lifted the curtain on a beleaguered agency, which appears to have ceded to state attorney generals and private plaintiffs the task of ferreting out facts and pursuing remedies on behalf of investors.

Background

The case arose out of the SEC's allegations against Bank of America, concerning its acquisition of Merrill Lynch & Co. The SEC alleged that Bank of America's publicly filed proxy statement was misleading. According to the complaint, notwithstanding the proxy statement's implication that Merrill was prohibited from paying bonuses under the terms of the merger agreement, the day before the merger closed, Merrill paid $3.6 billion in bonuses to its employees.

The SEC filed its complaint on August 3, 2009, and, together with Bank of America, filed that same day a joint proposed final consent judgment by which Bank of America, without admitting or denying the allegations, agreed to be enjoined from making future false statements in proxy statements and to pay a fine of $33 million. The complaint was filed seven months after a class-action complaint against Bank of America in connection with the merger[2] and numerous other class-action complaints and shareholder derivative actions that followed in short order.[3]

Judge Rakoff's Rejection of the *Bank of America* Settlement

Rather than simply endorsing the proposal, Judge Rakoff heard argument in August on whether it was fair and reasonable and then directed the parties to file written submissions in support. Finding the submissions inadequate, the court explicitly highlighted a list of its concerns, including the following:

- If the shareholders were the alleged principal victims, why did the SEC seek a penalty from the corporation, in apparent violation of its official policy to seek penalties from culpable individuals acting for the corporation?[4]
- Why did the SEC accept what it characterized as the individuals' advice-of-counsel defense in the absence of a waiver of attorney-client privilege?
- If such a waiver did occur, why didn't the SEC pursue an inquiry into whether the lawyers were legally responsible?[5]

The court directed the parties to provide supplemental submissions on the issues it raised.

Forced to expand on its earlier stance, the SEC found itself in the embarrassing position of contending that Bank of America had not waived the attorney-client privilege and that, having accepted at face value the assertions of key executives that they had delegated all relevant disclosure decisions to counsel, there was no evidence in the record of culpable conduct on the part of Bank of America individuals.[6] Bank of America, in turn, asserted that it had not relied on advice of counsel and never invoked the privilege; indeed, the bank maintained that there was nothing false or misleading about the proxy statement.[7]

In its stinging 12-page analysis, the court rejected the proposal, noting:

> In other words, the parties were proposing that the management of Bank of America—having allegedly hidden from the Bank's shareholders that as much as $5.8 billion of their money would be given as bonuses to the executives of Merrill who had run that company nearly into bankruptcy—would now settle the legal consequences of their lying by paying the S.E.C. $33 million more of their shareholders' money.[8]

Judge Rakoff then methodically analyzed the proposed settlement and concluded that, even under the most deferential standard, it failed to pass muster. First, it did not "comport with the most elementary notions of justice and morality" because, as the SEC admitted, the shareholders would indirectly bear the burden of paying the corporation's penalty. The court rejected as nonsensical the SEC's justification that the corporate penalty sent a signal to the shareholders that unsatisfactory corporate conduct had occurred, labeling "absurd" the notion that after having been lied to in connection with the "multi-billion-dollar purchase of a huge, nearly-bankrupt company," the shareholders needed to lose another $33 million of their money to better assess the quality of management. The court had little patience for the SEC's claim that it could not sue management because the company's attorneys had drafted the documents and made the disclosure decisions, reasoning that the SEC could sue the lawyers. In an explosive footnote, the court not only criticized the SEC for failing to consider whether the bank had waived its attorney-client privilege but suggested that the crime-fraud exception to the privilege might apply.

Judge Rakoff disposed of the question of reasonableness in similarly efficient fashion, explaining that it would be unreasonable to ask the victim to pay a fine for having been victimized; would close the case without the SEC accounting for

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why it violated its own policies in failing to pursue charges against management or the lawyers who were allegedly responsible for the proxy statements; and would require the court to enjoin the bank from issuing false and misleading statements when it denied that it had done so to begin with.

Finally, the court held that the proposed consent judgment was inadequate, noting that the injunctive relief was pointless and that $33 million was a trivial penalty for a false statement that materially affected a multi-billion dollar merger. Moreover, "since the fine is imposed, not on the individuals putatively responsible, but on the shareholders, it is worse than pointless: it further victimizes the victims." In what is by now an oft-quoted summary, the court concluded:

> The proposed Consent Judgment in this case suggests a rather cynical relationship between the parties: the SEC gets to claim that it is exposing wrongdoing on the part of the Bank of America in a high-profile merger; the Bank's management gets to claim that they have been coerced into an onerous settlement by overzealous regulators. And all this is done at the expense, not only of the shareholders, but also of the truth.

Having thus disapproved the consent judgment, the court set the case down for trial in February 2010. And despite what amounted to the court's invitation that the SEC sue Bank of America's management or its counsel, the SEC recently filed an amended complaint that merely fine-tuned the existing allegations against the company itself.

Comparisons to the *Worldcom* Settlement

Judge Rakoff's systematic deconstruction of the Bank of America settlement agreement, standing alone, is sufficient to justify its rejection. But the agreement suffers as well by unspoken comparison, for six years earlier Judge Rakoff presided over the SEC's settlement of one of the largest corporate scandals in history and was effusive in his praise of the agency's methods in that case.

The *WorldCom* decision[9] foreshadows Judge Rakoff's concerns—cast in stark relief in the Bank of America decision—with crafting a just resolution when confronted with individual wrongdoers and a corporation whose fate is tied to their conduct. *WorldCom* arose out of the SEC's civil lawsuit against the company, alleging that it committed a massive accounting fraud in which the company's income was overstated by an estimated $11 billion. While the former CEO of the company and its top financial officials were ultimately convicted in criminal proceedings brought by the Department of Justice, Judge Rakoff wrestled with what constituted an appropriate monetary penalty in the SEC's action against the company itself. The decision's opening paragraph summarizes the tension, noting that "[w]hile the persons who perpetrated the fraud can be criminally prosecuted, the exposure of the fraud often creates liquidity pressures that can drive the company into bankruptcy, leaving unsecured creditors with little and shareholders with nothing."

In the court's view, the WorldCom proposal had the benefit of good-faith self-scrutiny, including the installation of new management, the company's consent to the appointment of a corporate monitor, the company's unqualified support of the monitor's efforts to initiate "vast improvements" in the company's models of corporate governance and internal compliance (such as the expenditure of over $50 million to fund unrestricted internal and external investigations), and the firing of those who were accused of complicity in the fraud or who were insufficiently attentive in preventing it. Noting that it was satisfied that the SEC had "carefully reviewed all relevant considerations" and "arrived at a penalty that, while taking adequate account of the magnitude of the fraud the need for punishment and deterrence, fairly and reasonably reflects the realities of this complex situation," the court approved a proposed settlement that assessed a monetary penalty to be paid to a court-appointed distribution agent. Upon request of the SEC in that case, the penalty was placed in a Fair Fund for the benefit of the investor victims,[10] and four years after the court-approved settlement, the SEC announced that it had distributed over $500 million to investor victims of the WorldCom accounting fraud.[11]

WorldCom, then, perhaps foreshadows Judge Rakoff's barely concealed disdain for the proposed settlement in Bank of America, for in the court's view, the latter was intellectually dishonest and made no effort to address the true ills presented by the case—it proposed a settlement figure that had no bearing on the magnitude of the fraud, punished no one except the innocent shareholders, and left management in place and free to perpetrate the same wrongdoing without penalty. Indeed, in the aftermath of the Madoff case and the SEC's failure to detect that fraud, it may have presented a situation even more egregious to the court—a fraud that the SEC did ultimately act upon, but for which it imposed superficial and ill-conceived punishment.

What Can We Learn from the *Bank of America* Decision?

Accepting *arguendo* the logical correctness of Judge Rakoff's methodical analysis and the conclusion to which it inexorably leads, what are its ramifications? Fearing closer judicial scrutiny of its proposed consent judgments, the SEC may conduct more vigorous investigations, with closer attention to the conduct of individuals. Rather than abdicating to shareholder class actions and derivative suits to recoup losses, it may craft dispositions better designed to punish wrongdoers and compensate defrauded investors.

However, while these may prove beneficial byproducts of the decision, the decision may just as easily constitute a well-founded rebuke to the SEC at the further expense of the company and its shareholders. First, the shareholders are now required to pay for litigation costs and any resulting penalty after verdict, which will likely be higher than that proposed in the settlement. If the verdict favors the defense, the company and, by extension, its management, will be exonerated. But the shareholders will have incurred the expense, and management the distraction, of the litigation.

Second, while the court's criticism of the SEC's methodology may have been

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logical, its rejection of Bank of America's explanation that it agreed to the proposal as a function of business judgment—that is, settling a lawsuit is cheaper than litigating it—gave too short shrift to that analysis. The perils of a trial do justify settlement on relatively favorable terms. However, under Judge Rakoff's rationale, defense counsel might have legitimate concerns that they have negotiated too well for their client and secured a penalty that was too low to pass judicial scrutiny.

Third, while Judge Rakoff may have intended to challenge the SEC to reassess its charging decision, instead the SEC responded by defending those judgments and is now on record as holding the view that there is no appropriate evidentiary basis to charge either the company's executives or its attorneys. Should the SEC seek to amend the complaint at a later date to include these individuals, it will have to support that application with additional evidence that it will be required to seek from the company and its personnel, generating further expense and creating further distraction to the company.

Fourth, Judge Rakoff's decision focused in large part on attorney-client privilege and work-product protections with respect to the disclosures made in, or omitted from, the proxy statement filed in connection with the merger. Under pressure from the New York State Attorney General's Office[12] and Congress,[13] the company recently filed a stipulated agreement and protective order in which it agreed to disclose otherwise protected information to the SEC, Congress, and specific state and federal agencies (including the New York State Attorney General's Office) while otherwise limiting its waiver of the attorney-client and work-product privileges.[14] However, the company has previously denied that it is relying on advice of counsel as a defense and, while advice of counsel is a relevant consideration, it rarely serves as a complete defense. Indeed, the success of such a position requires that the company fully disclose to counsel all of the pertinent facts, and so the likely effect of such waiver will simply be the distraction of outside counsel being forced into the spotlight and required to point fingers at its former client in order to defend itself. This development also ensures that other agencies, including the New York State Attorney General's Office, will be investigating the role of the attorneys, even as it is unclear whether Bank of America would assert or prevail upon advice of counsel as a defense in its upcoming trial.

Finally, the ripple effect of Judge Rakoff's decision may yet be seen in the coming months. No doubt prompted by the company's waiver of attorney-client privilege, plaintiffs in at least one stockholder derivative lawsuit against Bank of America have reportedly now received permission to subpoena documents pertaining to the merger from the bank's outside counsel, including those otherwise subject to attorney-client privilege and work-product protection.[15] While private plaintiffs cannot pursue an aiding-and-abetting claim,[16] which is the prerogative of the SEC alone,[17] if they gain access to otherwise privileged material, it will no doubt prove fertile ground for additional claims against the company and/or its management. The ironic aftermath of Judge Rakoff's decision therefore may be that, while it does little to prompt the SEC to reassess its methodology, it may increase or prolong shareholder suits against the company, with attendant cost to the company. That hardly seems to have been the intended result of the decision. ■

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Endnotes

1. *See* SEC v. Bank of Am. Corp., No. 09 Civ. 6829 (S.D.N.Y. 2009).
2. *See* Sklar v. Bank of Am. Corp., No. 09 Civ. 0580 (S.D.N.Y. 2009).
3. In an order entered on February 25, 2009, in *Sklar*, Judge Denny Chin noted there were pending in the Southern District alone at least 22 actions relating to the merger and the public disclosures in connection with that transaction, including putative class actions, derivative actions, and actions asserting claims under ERISA on behalf of participants in Bank of America's 401(k) plan that held investments in Bank of America stock. *See* Order, Sklar v. Bank of Am. Corp., No. 09 Civ. 0580 (S.D.N.Y. Feb. 25, 2009).
4. Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties, SEC Press Release No. 2006-4 (Jan. 4, 2006) ("Where shareholders have been victimized by the violative conduct, or by the resulting negative effect on the entity following its discovery, the Commission is expected to seek penalties from culpable individual offenders acting for a corporation.").
5. Order, SEC v. Bank of Am. Corp., No. 09 Civ. 6829 (S.D.N.Y. Aug. 25, 2009).
6. Memorandum of Plaintiff SEC in Support of Entry of the Proposed Consent Judgment at 4–5, 25, SEC v. Bank of Am. Corp., No. 09 Civ. 6829 (S.D.N.Y. Aug. 24, 2009).
7. Reply Memorandum of Law on Behalf of Bank of America Corp. at 1–2, 6, SEC v. Bank of Am. Corp., No. 09 Civ. 6829 (S.D.N.Y. Sept. 9, 2009).
8. Memorandum Order at 2, SEC v. Bank of Am. Corp., No. 09 Civ. 6829 (S.D.N.Y. Sept. 14, 2009).
9. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003).
10. A Fair Fund is a fund established by the SEC pursuant to section 308 of the Sarbanes-Oxley Act for the distribution of civil penalties and disgorgement to victims of securities fraud.
11. Press Release, SEC Distributions to WorldCom Fraud Victims Top Half-Billion Dollar Mark, SEC Press Release No. 2007-118 (June 14, 2007).
12. Letter from David A. Markowitz, Bureau Chief, Investor Protection Bureau, to Lewis J. Liman, Esq. (Sept. 8, 2009), *available at* www.oag.state.ny.us/media_center/2009/sep/BofA%20Letter%2009.08.09.pdf.
13. *See* Press Release, House Oversight and Government Reform Committee, Oversight Committee to Examine BofA-Merrill Lynch Merger (Nov. 16, 2009), *available at* http://oversight.house.gov/index.php?view=article&catid=3%3Apress-releases&id=4677%3 Aoversight-committee-to-examine-bofa-merrill-lynch-merger&format=pdf&option= com_content&Itemid=49.
14. Order and accompanying Disclosure Stipulation Agreement and Proposed Protective Order, SEC v. Bank of Am. Corp., No. 09 Civ. 6829 (S.D.N.Y. Oct. 14, 2009).
15. *See* Christie Smythe, *BofA Shareholders Get Green Light to Query Firms*, Law360.com, Nov. 6, 2009, *available at* www.law360.com/articles/132793.
16. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) (Private actions under 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder can only be brought against primary violators and not against those who aid and abet a primary violator.).
17. 15 U.S.C. § 78t(e) (authorizing SEC to prosecute persons who knowingly provide "substantial assistance" to another person who is in violation of the securities law).

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