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Second Circuit Rules Plaintiffs' Securities Class Action Cannot Ride the Coattails of Foreign Bank's Regulatory Troubles

Securities Litigation Quick Read

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A recent decision out of the Second Circuit Court of Appeals sets limits on plaintiffs' ability to transform regulatory violations into the basis for securities class actions. The decision further clarifies that issuers do not face liability for historically accurate statements that later discovered misconduct renders misleading. Finally, the decision provides guidance on the heightened pleading standards plaintiffs must satisfy when bringing claims under Rules 10b-5(a) and (c) and reaffirms that the different standards under these rules — as opposed to the more familiar Rule 10b-5(b) — do not excuse plaintiffs from the requirement of pleading misconduct with specificity.

The case, *Plumbers & Steamfitters Local 773 Pension Fund v. Danske Bank A/S*, centered around alleged violations of anti-money laundering (AML) rules by Danske Bank's Estonian branch.[1] Danske Bank, Denmark's largest financial institution, acquired the Estonian Branch in 2006, and shortly thereafter, the branch was censured by the Estonian Financial Supervisory Authority. At the same time, the Danish Financial Supervisory Authority approached Danske Bank about AML issues in the Estonian branch. When Danske Bank acquired the Estonian branch, it inherited a portfolio of nonresident customers, which was the source of most of the branch's AML issues. This group of customers — based primarily in Russia and the United Kingdom — also accounted for a sizable portion of the branch's profits. In late 2013, a whistleblower in the Estonian branch emailed supervisors in Copenhagen to report a "near total process failure" and to accuse branch employees of "knowingly dealing with criminals."[2] The whistleblower's claims were substantiated by Danske Bank's internal audit group, and as a result, Danske Bank started to wind down the Estonian branch's foreign customer business.

In March 2016, Danish regulators publicly reprimanded and fined Danske Bank for AML violations in the Estonian branch. In 2017, a Danish newspaper published an investigation detailing how more than $20 billion was laundered out of Russia in three years, including through Danske Bank's Estonian branch. The public revelation of the AML issues brought on further investigations and bad publicity, and Danske Bank hired a Danish law firm to handle an internal investigation. In September 2018, the internal investigation revealed that the scandal was even larger than initially suspected, with over $200 billion worth of suspect transactions. Danske Bank's CEO resigned, and the share price plummeted.

The pension fund brought a class action, seeking to represent holders of Danske Bank's American Depositary Receipts (ADRs). The pension fund purchased the ADRs in 2018 after the Estonian branch's AML issues were known publicly, but before the results of the internal investigation were released. The pension fund identified five categories of alleged misstatements and omissions on: (1) Danske Bank's financial statements; (2) Danske

Bank's statements about its goodwill impairments; (3) statements about the whistleblower system; (4) corporate governance statements discussing AML compliance; and (5) Danske Bank's assertion before the release of the internal investigation that it did not expect the growing AML scandal to materially impact its financial position. The district court granted Danske Bank's motion to dismiss, and the Second Circuit affirmed, agreeing that none of the five categories of misstatements or omissions were actionable.

The plaintiffs alleged Danske Bank's financial reports were misleading because its financial statements included profits from alleged money laundering, and it was misleading for Danske Bank to release the statements "without simultaneously disclosing what [the bank] knew about possible money laundering at the [Estonian] branch."[3] On the first claim, the court found that the plaintiffs had not pled with particularity any violation of accounting standards because the financial statements were historically accurate, and the plaintiffs failed to identify specific accounting standards that Danske Bank breached.[4] Danske Bank similarly did not have an obligation to disclose vague suspicions of AML issues in its financial statements. "'[D]isclosure is not a rite of confession,' so 'companies do not have a duty to disclose uncharged, unadjudicated wrongdoing.'"[5] The court reasoned that, "[o]therwise, every company whose quarterly financial reports included revenue from transactions that violated AML regulations could be sued for securities fraud" and thus overextend the reach of federal securities laws.[6]

In dismissing the plaintiffs' allegations as to statements about Danske Bank's 2014 goodwill impairment, the court noted that "almost 39 months intervened" between the impairment and plaintiffs' ADR purchases. Thus, the court observed, while determining the materiality of an alleged misstatement is normally a "fact-specific inquiry," the length of time between the misstatements and the ADR purchases made it "implausible that the fine points of a technical accounting exercise conducted back in 2014 'significantly altered the total mix of information'" available to the plaintiffs at the time of their ADR purchases.[7] The court relied on similar logic to find that the alleged misstatements in categories (3) through (5) were too vague and remote from the plaintiffs' purchases of Danske Bank's ADRs to have materially altered the information available at the time of their ADR purchases.

Finally, the plaintiffs also alleged that Danske Bank violated subsections (a) and (c) of Rule 10b-5 by engaging in deceptive conduct. While noting that these claims "do not require the defendant to make a misstatement or omission — they require only deceptive conduct" — the court emphasized that these claims still require specific pleadings.[8] "Absent some sort of enumeration of which specific acts constituted an alleged scheme in connection with the purchase or sale of securities," the plaintiffs' claims could not move forward.[9] "Money-laundering at a single branch in Estonia cannot alone establish that Danske Bank itself carried out a deceptive scheme to defraud investors."[10]

The court's decision provides important guidance to issuers — especially financial institutions — about the applicability of federal securities laws to allegations of misconduct or regulatory violations. The court emphasized that "historically accurate" statements do not by themselves support securities claims and are not rendered actionable simply because violations are later discovered, so long as the statements were made without knowledge or intent to mislead investors. Similarly, plaintiffs cannot sidestep the heightened pleading requirements of the PSLRA by simply outlining a general scheme of misconduct and then claiming that such a scheme was intended to defraud investors. The decision reaffirms the general principle that plaintiffs cannot transform allegations of regulatory or other legal troubles — such as the AML troubles from which Danske Bank suffered — into securities law claims without specifically connecting the legal or regulatory issues to misstatements, omissions, or schemes made with the aim of defrauding investors.

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[1] No. 20-3231, 2021 WL 3744894 (2d Cir. Aug. 25, 2021).

[2] *Id.* at *2.

[3] *Id.* at *4.

[4] *Id.*

[5] *Id.* (quoting *City of Pontiac Policemen's and Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 184 (2d. Cir. 2014)).

[6] *Id.*

[7] *Id.* at *5-6 (quoting *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976); *Basic v. Levinson*, 458 U.S. 224, 240 (1988)) (other citations omitted).

[8] *Id.*, at *9 (citations omitted).

[9] *Id.*

[10] *Id.*

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