

Reproduced with permission from Daily Report for Executives, 157 DER, 8/14/15. Copyright © 2015 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Corporate Governance

Second Circuit Seeks Advice in JPM Case, Adopts Tougher Standard for Derivative Suits

A federal appeals court asked for the Delaware Supreme Court's advice in a \$6.25 billion suit against JPMorgan's Chase & Co.'s board of directors that could reshape how boards respond to allegations of wrongdoing (*Espinoza v. Dimon*, 2d Cir., No. 14-cv-01754, *question certified*, 8/12/15).

In an order late Aug. 12, the U.S. Court of Appeals for the Second Circuit asked what standard Delaware law applies when a shareholder challenges the scope of a board's investigation of his demand.

"If a shareholder demands that a board of directors investigate both an underlying wrongdoing and subsequent misstatements by corporate officers about that wrongdoing, what factors should a court consider in deciding whether the board acted in a grossly negligent fashion by focusing its investigation solely on the underlying wrongdoing?" the Second Circuit asked the Delaware court.

The Delaware court is not required to address the question.

The case involves a derivative suit by Ernesto Espinoza, who said JPMorgan's board failed to take seriously his demand for action against JPMorgan officials he said were partly responsible for trading losses in 2012.

New Standard Adopted. The Second Circuit's action also is significant because the court discarded a 30-year stance on how it reviews dismissals of shareholder derivative suits, so-called because plaintiffs claim to sue on behalf of the corporation.

Although the Second Circuit traditionally has reviewed those decisions for abuse of discretion, it will now apply a higher standard by reviewing those dismissals afresh.

"Accordingly, we today revisit the standard of review and hold that dismissals of derivative actions are reviewed de novo," Chief Judge Robert A. Katzmann said.

Special Impact Likely. The Second Circuit is not the first federal appeals court to adopt the de novo standard with respect to dismissed derivative suits.

The First and Seventh Circuits have adopted it already, and other courts have raised questions about continued use to the abuse of discretion standard.

But the ruling may have special force in the Second Circuit—frequently a forum for critical cases involving U.S. companies and multinationals.

The plaintiff, Ernesto Espinoza, is represented by George Aguilar and Jay Razzouk of Robbins Arroyo in San Diego. In an Aug. 13 statement, Aguilar cheered the Second Circuit's decision to change the standard of review.

"There is no persuasive reason for reviewing dismissals of derivative actions differently than dismissals of virtually all other cases, including securities class actions and other types of shareholder actions," he said.

More Whale Fallout. The Aug. 12 order marks the latest fallout from trading losses in 2012 by Bruno Iksil, a trader nicknamed the "London Whale" because of the size of his trading positions.

JPMorgan has faced numerous lawsuits by shareholders since that time, while paying more than \$1 billion in fines leveled by U.S. and U.K. regulators who alleged management failings and violations of securities laws.

JPMorgan spokesman Andrew Gray Aug. 13 declined to comment on the Aug. 12 order.

Suit Alleges Inaction. According to the court, Espinoza said the board only examined the underlying trading losses, but did not explore alleged misstatements by JPMorgan President and Chief Executive Officer Jamie Dimon and other executives.

Among other statements, the suit said, Dimon initially labeled media focus on the losses as a "tempest in a teapot," but later disclosed multibillion-dollar losses and criticized the trades.

Espinoza sued in 2013, alleging \$6.25 billion in losses. A district court dismissed his suit in 2014.

In June, the Second Circuit affirmed the district court, using the abuse of discretion standard, but was quickly met with a petition to rehear the case.

In its Aug. 12 order, the Second Circuit acted on its own motion, denying the motion to rehear.

The court withdrew the June ruling, and substituted the Aug. 12 decision.

Order Called Significant. Dennis M. Kelleher, president and chief executive officer of Better Markets, a Washington, D.C.-based nonprofit public policy group with a focus on financial services, Aug. 13 called the Second Circuit's action important.

"It's impossible to overstate the significance of this decision, which is a major victory for shareholders and shareholder rights," Kelleher said. "The change from the low abuse of discretion standard to de novo review really is quite significant," he said.

He said it makes sense for the Second Circuit to certify a question on the scope of the board's investigation.

“This was not a conclusory or minor aspect of the demand request,” he said, referring to Espinoza’s demand for action by JPMorgan’s board. “It really does highlight one of the key issues from the beginning here, which is that no one is fully scrutinizing the conduct, action, and words of Jamie Dimon,” Kelleher said.

Kelleher and Better Markets have been frequent critics of JPMorgan and Dimon. In 2015, a federal judge rejected the group’s bid to challenge a \$13 billion mortgage settlement between JPMorgan and the U.S. government, saying Better Markets lacked standing (54 DER EE-3, 3/20/15).

BY CHRIS BRUCE

To contact the reporter on this story: Chris Bruce in Washington at cbruce@bna.com

To contact the editor responsible for this story: Mike Ferullo at mferullo@bna.com

The Second Circuit’s order is at http://www.bloomberglaw.com/public/document/Espinoza_v_Dimon_Docket_No_1401754_2d_Cir_May_06_2014_Court_Docke/2. Espinoza’s complaint is at http://www.bloomberglaw.com/public/document/Espinoza_v_Dimon_et_al_Docket_No_113cv02358_SDNY_Apr_09_2013_Cour.